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2015

Role of the Central Bank in supporting economic diversification and productive employment in Cambodia

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Preface

The primary goal of the ILO is to work with member States towards achieving full and productive employment and decent work for all. This goal is elaborated in the ILO Declaration 2008 on *Social Justice for a Fair Globalization*,[1] which has been widely adopted by the international community. Comprehensive and integrated perspectives to achieve this goal are embedded in the Employment Policy Convention of 1964 (No. 122), the *Global Employment Agenda* (2003) and – in response to the 2008 global economic crisis – the *Global Jobs Pact* (2009) and the conclusions of the *Recurrent Discussion Reports on Employment* (2010 and 2014).

The Employment Policy Department (EMPLOYMENT) is engaged in global advocacy and in supporting member States in placing more and better jobs at the center of economic and social policies and growth and development strategies. Policy research and knowledge generation and dissemination are essential components of the Employment Policy Department's activities. The resulting publications include books, country policy reviews, policy and research briefs, and working papers.[2]

The *Employment Policy Working Paper* series is designed to disseminate the main findings of research on a broad range of topics undertaken by the branches of the Department. The working papers are intended to encourage the exchange of ideas and to stimulate debate. The views expressed within them are the responsibility of the authors and do not necessarily represent those of the ILO.

Azita Berar Awad
Director
Employment Policy Department

[1] See http://www.ilo.org/public/english/bureau/dgo/download/dg_announce_en.pdf

[2] See http://www.ilo.org/employment.

Foreword

This study was undertaken by a team from the National Bank of Cambodia (NBC). It is a prime example of collaboration between a major national institution responsible for the conduct of monetary and financial policy and the ILO.

During the last two decades, Cambodia has witnessed high economic growth and stable macroeconomic conditions. However, the fundamentals of the economy are narrowly based and depend greatly on foreign demand, which makes it vulnerable to external shocks. Consequently, Cambodia needs to diversify its economy to achieve more stable growth to expand its capacity to employ people more productively. The Government has incorporated a plan to diversify the economy into its Rectangular Strategy as well as other sub-national and sectoral development programmes.

As monetary authority and regulatory and supervisory authority of the banking system, the NBC has actively promoted economic growth and diversification, and employment creation. Moreover, the NBC’s missions and functions have become increasingly crucial, especially in the aftermath of the recent global financial crisis. The NBC’s monetary policy supports macroeconomic stability in Cambodia which attracts a continuing inflow of foreign investment. The NBC also promotes and maintains financial system stability and development through promotion of financial inclusion, oversight of the payments system and regulation of the banking system. This has contributed to the efficient channelling of financial resources for capital accumulation in Cambodia over time.

However, Cambodia faces several hurdles in fostering economic diversification and employment in more productive jobs. The dollarized financial system in combination with the NBC's policy of managing the exchange rate imposes significant constraints. Many SMEs are not registered and do not have audited financial statements. In order to overcome these constraints, the NBC would have to engage in a wide range of institutional innovations that will enhance confidence in the financial system and widen the ambit of financial inclusion.

Iyanatul Islam
Chief
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The authors would also like to extend their heartfelt thanks to the NBC's technical experts as well as the interviewees who kindly agreed to meet with us and give their precious time and thoughts on the topic. In particular, the authors would like to express their gratitude to the following: Mr Ros Seileva, Secretary of State of the Ministry of Economy and Finance, Mr Heng Sour, Secretary of State of the Ministry of Labour and Vocational Training; Mr Hai Sovuthea, Senior Economist at the Supreme National Economic Council, Dr In Channy, President of ACLEDA Bank Plc; Dr Bun Mony, Chief Executive Officer of SATHAPANA Limited; Mr Chea Phalarin, Chief Executive Officer of Amret Microfinance Institution, Mr Oum Sophan, Chief Finance Officer of PRASAC Microfinance Institution; Mr Stephen Higgins, Chief Executive Officer of the ANZ Royal Bank, Phnom Penh; Mr Ly Sodéth, Economist at the World Bank, Phnom Penh; Mr Enrique Aldaz-Carroll, Senior Country Economist for the World Bank, Phnom Penh; Mr Doung Poullang; Economist at the Asian Development Bank, Phnom Penh; and Mr Heng Dyna, former President of the Cambodia Economic Association.

Last but not least, the authors would also like to express their deep appreciation to colleagues within the National Bank of Cambodia who provided relevant data and information.

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Introduction[3]

Cambodia's economy has experienced strong growth during the last two decades despite the global financial crisis. The growth has markedly lifted the living standards of the Cambodian people, with a significant reduction in the poverty rate and rising employment. However, the economy is still based on a few sectors, which mainly rely on external demand. Therefore, there is a need, generally recognized, to further diversify its economic base so as to achieve sustainable economic growth and employment creation.

The Royal Government of Cambodia has laid out plans and reform programmes to support economic growth and diversification, as well as creation of employment. These require the involvement of stakeholders from both public and private sectors. As monetary and supervisory authority, the National Bank of Cambodia has played an important role in realizing these goals.

The recent global financial crisis has left a big scar on the global economy, and many countries suffered losses in terms of economic growth and employment. The ILO (2013) estimated that the crisis cost 28 million jobs and approximately 39 million workers left the labour force due to their gloomy prospects. Low employment not only constrains the quantity and quality of production but also poses a lingering threat to social stability and the wellbeing of the population, as well as undermining the goals of reducing poverty and fostering development.

Following the crisis, low employment in developing countries might not seem as severe as that in the developed countries. However, measuring employment in developing countries is more problematic, given that a large share of their labour consists of informal workers, including self-employed and casual labourers (Ghost et al, 2008). This informal employment, which covers most of the poor, implies greater vulnerability of these countries to economic and social problems, and thus demands greater attention from government.

Governments in developed and developing countries alike now face fiscal constraints that limit their ability to boost growth and productive employment. Consequently, their central banks have considered ways of compensating by using both traditional and unconventional monetary policy instruments to foster growth. The question then arises whether central banks should be more active, departing from their previous practice, pursuing economic growth and promoting employment. If so, how can they do so most effectively? These questions have inspired considerable debate, which in turn has stimulated much research in many countries.

In Cambodia, like other developing countries, the Government has been pursuing various policies to boost economic development, reduce poverty, and expand employment.[4] Over the past two decades, Cambodia has made significant progress. Cambodia's average growth of 8 per cent per annum has reduced its poverty rate from 48 per cent in 2007 to 18.9 per cent in 2012 (National Institute of Statistics (NIS) and World Bank). However, many people who escaped poverty are still at high risk of falling back into poverty. Although

[3]The responsibility for opinions expressed in articles, studies and other contributions rests solely with their authors. It does not constitute endorsement by the National Bank of Cambodia of the opinions expressed therein, or of any products, processes or geographical designations mentioned.
[4]The Cambodian Government has been implementing reforms under the Rectangular Strategy, the National Strategic Development Plan and other sectorial policies.

strong growth has reduced poverty, Cambodia still faces the challenge of achieving a higher standard of living for many of its workers.

Cambodia’s economy remains vulnerable, because its performance relies mainly on growth in a few sectors, such as agriculture, exports of garments, tourism, and construction. Furthermore, these sectors, excluding construction, are quite sensitive to the global economy. Consequently, growth in Cambodia fell significantly in 2009. Following this experience, the Government recognized the need to diversify the economy while at the same time promoting productive employment.

Because the Government is constrained by its fiscal resources, this paper explores the ways the central bank, the National Bank of Cambodia (NBC), has supported economic diversification, growth, and employment. The case of Cambodia is quite unique because it is a highly dollarized economy, which limits the NBC's ability to conduct monetary policy effectively. Consequently, studying the role of central banks in promoting diversification and growth becomes especially interesting and worth exploring for Cambodia.

This paper describes the roles and functions of the National Bank of Cambodia in promoting economic growth, employment and supporting economic diversification in Cambodia by exploring its current and potential roles.

The study drew on the experiences of other central banks in previous studies as agents of economic development and employment creation. The case of the National Bank of Cambodia is carefully analysed in this paper.

Complementing the theoretical aspects, a survey was conducted into the relevant public and private sector entities as well as international financial institutions in order to gather their views on the role of the NBC in supporting economic growth, diversification and job creation. Eighteen representatives of these institutions were interviewed, including senior economists and officials from the Asian Development Bank (ADB), Supreme National Economic Council (SNEC), World Bank, and Cambodian Economic Association (CEA), trade unions, banks and financial institutions. Key policy makers in the Ministry of Economy and Finance (MEF), and Ministry of Labour and Vocational Training (MOLVT) were also interviewed. Separate questionnaires were prepared for different government ministries, banking institutions, and other think tanks and the results were incorporated in the paper.

The paper is organized as follows. Section 1 provides a brief overview of Cambodia’s development and employment challenges. Section 2 surveys the literature on the roles of monetary policy, financial policy, and payment systems in promoting economic growth and diversification and employment creation. It also introduces the constraints on those policies in the context of dollarization. The third section analyses the case of Cambodia both the missions and functions of its central bank. Section 4 presents the challenges facing the NBC and what it can do to contribute to economic diversification and creation of productive employment. The last section is devoted to the paper’s summary and conclusions.

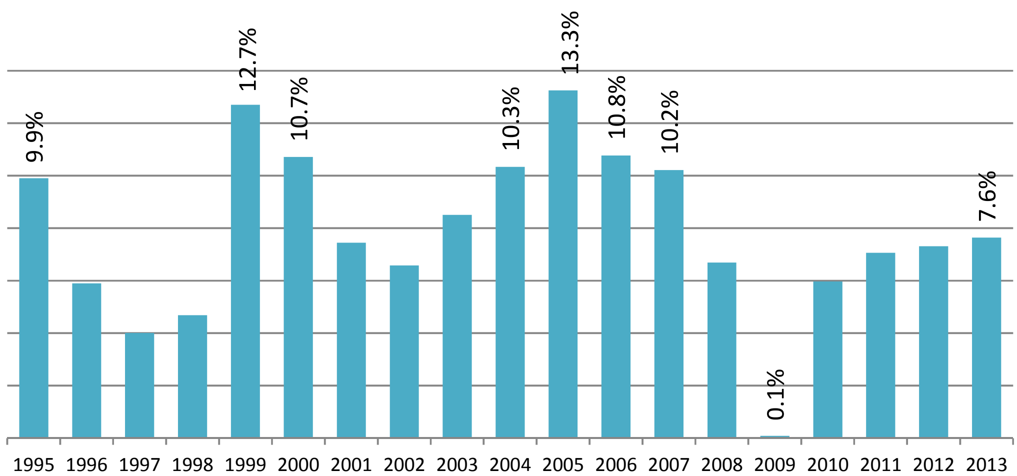
1. Cambodia's development and employment challenges

After more than two decades of Civil War, Cambodia adopted a free market economy in 1993, following the first general election conducted under the auspices of the United Nations Transitional Authority of Cambodia (UNTAC). Afterwards, Cambodia adopted comprehensive macroeconomic and structural reforms. As it liberalized trade and investment, it attracted foreign investors, and its exports expanded significantly. Accordingly, the country has enjoyed high economic growth, created many new jobs, and reduced the incidence of poverty.

1.1. Macroeconomic performance and sectoral structure of the Cambodian economy

Following the Paris Peace Agreement[5] in 1991 and its transformation to a market economy in 1993, Cambodia has made impressive economic and social progress in rebuilding its infrastructure, institutions, and social and human capital (Asian Development Bank (ADB), 2008). After peace was fully restored across the country in the late 1990s, Cambodia's Gross Domestic Product (GDP) grew at an average annual rate of 8 per cent and per capita income rose by an average of 7 per cent.

Figure 1. Cambodia's GDP growth rate (constant 2000 prices)



Source: National Institute of Statistics, Ministry of Planning

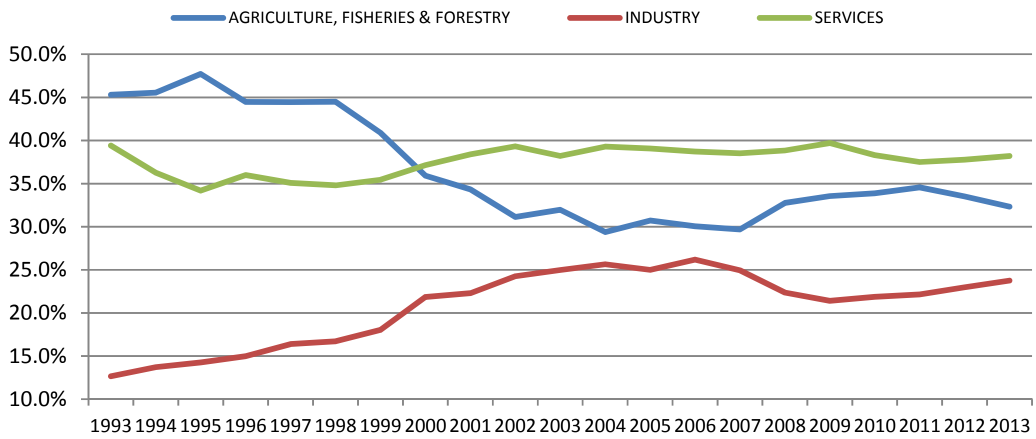
Full restoration of political stability and the implementation of the Triangular Strategy boosted economic development significantly (Naron, 2009). The Government also supported economic growth by fostering the expansion of private enterprises through various reform programmes[6] that encourage investment and trade. Those reforms have attracted large inflows of foreign direct investment (FDI) particularly in the garment, tourism, and real estate industries (Naron, 2009).

[5] This was the agreement which put an end to two decades of civil war in Cambodia.
[6] Cambodia has implemented wide variety of reforms focusing on macroeconomic management, public financial management and the financial sector, and rehabilitation and reconstruction of physical infrastructure.

Between 1993 and 1998, agriculture accounted for almost half of GDP. After 1999, the share of agriculture fell significantly as the contribution of the industrial sector increased to one third. Since 2002, agriculture has accounted for about one third of GDP, and industry has accounted for one quarter. Recently, tourism and construction also have contributed significantly to the growth of the economy.

Since 2007, agricultural output has grown more rapidly than GDP as Cambodia exported more food. In 2013, to support agricultural exports, the Government set a target to export one million tons of rice by 2015, after the European Union relaxed constraints on imports in 2009, which allows Cambodia to export more food products to the EU.

Figure 2. Contributions to growth by sector



Source: National Institute of Statistics, Ministry of Planning

Although Cambodia has grown rapidly as a result of its industrial development, its economy is too dependent on exports. Because exports of garments and agricultural products, as well as tourism can react sharply to external shocks, Cambodia has become more vulnerable to global business cycles. For example, the recession in many of its export markets in 2009 reduced Cambodia's growth rate to just 0.1 per cent, down from 6.7 per cent in 2008. Garments alone lost 40,000 jobs (Naron, 2009). As garments, tourism, and construction contracted, private investment also declined. Because it depends so much on exports, tourism and FDI[7], Cambodia needs to diversify the economy to stabilize its rate of development in the future.

1.2. Employment, poverty and inequality in Cambodia

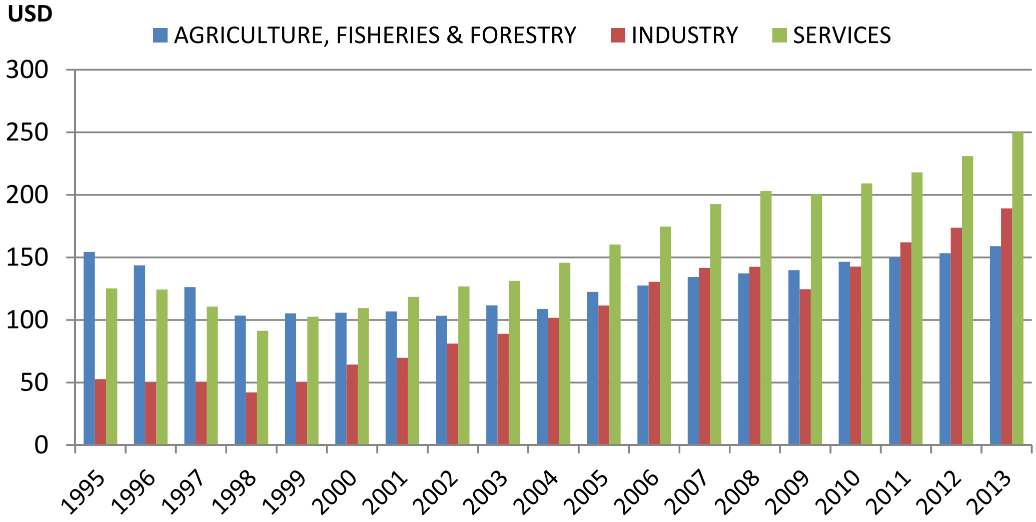
According to the Rectangular Strategy, Phase II, the economy is narrowly based on four main sectors: garment, tourism, construction and agriculture. The garment and tourism sectors are vulnerable to external risks. Agriculture, which shares 30 per cent of GDP and

[7] Although growth picked up quickly in 2010, downside risks remained. Exports led by the garment sector are concentrated mainly on the U.S. and European Union markets while the tourism sector is dependent on foreign countries' growth prospects.

accounts for more than 60 per cent of total employment, has not reached its full potential. As a result, employment in Cambodia, like output, is vulnerable to external economic conditions and therefore, needs to diversify its economy.

The country's strong growth has raised its workers' living standards. Average per capita household consumption rose by 32 per cent in real terms between 1994 and 2004. Calorie intake per capita rose steadily to reach 2,932 calories per day. Rapid growth also has significantly improved human development[8] in Cambodia. From 1993 to 2012, life expectancy at birth increased by 15 years, from 56.5 to 71.4 years[9]. School enrolment increased from 92.7 per cent in 1997 to 124.1 per cent[10] in 2012, reflecting better access to education in the country. During the same period, public health expenditure increased from 23.8 per cent to 24.7 per cent of total public and private health expenditure. Education plays a key role in raising economic growth and reducing poverty.

Figure 3. Real GDP per capita by sector



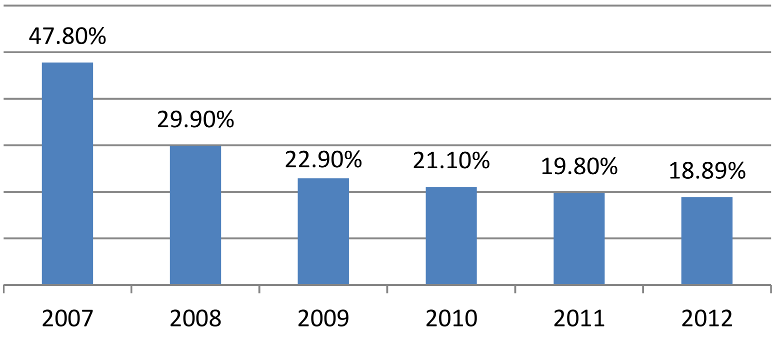
Source: National Institute of Statistics, Ministry of Planning

High growth reduced the poverty rate in Cambodia from 47.8 per cent in 2004 to 18.9 per cent in 2012[11]. Figure 3 shows that output per capita has been rising in the services and manufacturing industries since 1998, while remaining relatively stable in agriculture. This suggests that rising incomes in both the services and manufacturing sector have also been contributing factors to the reduction in poverty over recent years. According to the World

[8]The Human Development Indicator includes: life expectancy at birth, educational attainments and providing decent living standards measured in Gross National Income (GNI) per capita and purchasing power parity (PPP).
[9] World Bank data.
[10]This is gross primary school enrolment ratio regardless of age, expressed as age of the population of official primary education age. The ratio can exceed 100% due to the inclusion of over-aged and under-aged students because of early or late school entrance and grade repetition, according to the World Bank.
[11] Ministry of Planning.

Bank, the Gini index[12] for Cambodia was 38.2 in 1994 compared to 36.0 in 2009. Although the incidence of poverty fell markedly, inequality is still high.

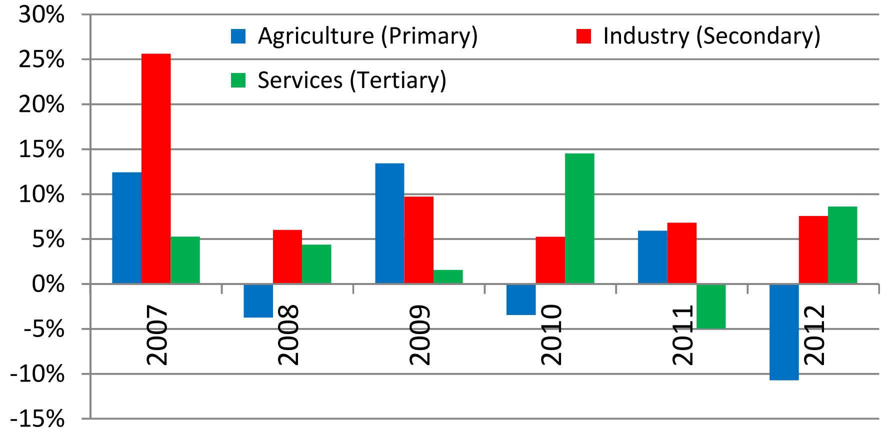
Figure 4. Poverty rate for different years, using the new poverty line 2009



Source: CSES, National Institute of Statistics, Ministry of Planning

Although Cambodia has become more industrialized, about 80 per cent of the population still lives in the rural areas where poverty remains obstinately high at 40 per cent. In 2012, around 70 per cent of the population worked in the informal economy, mostly in agriculture, forestry, and fishing and in small and micro-enterprises (Cambodia Socio-Economic Survey (CSES) data).

Figure 5. Employment growth rate by sector

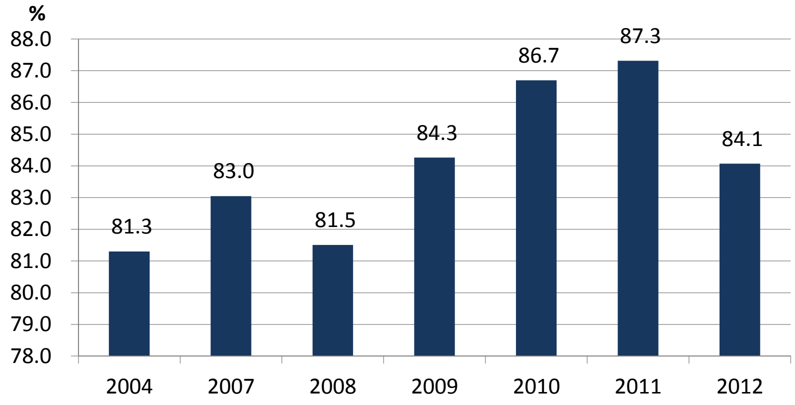


Source: CSES, National Institute of Statistics, Ministry of Planning

The formal garments and tourism sectors account for most of Cambodia's growth, with garment manufacturing providing on average 80 per cent of Cambodia’s exports during 2007 - 2013 and employing some 500,000 workers (GMAC, June 2013), mostly women.

[12]World Bank definition: “Gini index measures the extent to which the distribution of income or consumption expenditure among individuals or households within an economy deviates from a perfectly equal distribution… A Gini index of 0 represents perfect equality, while an index of 100 implies perfect inequality.”

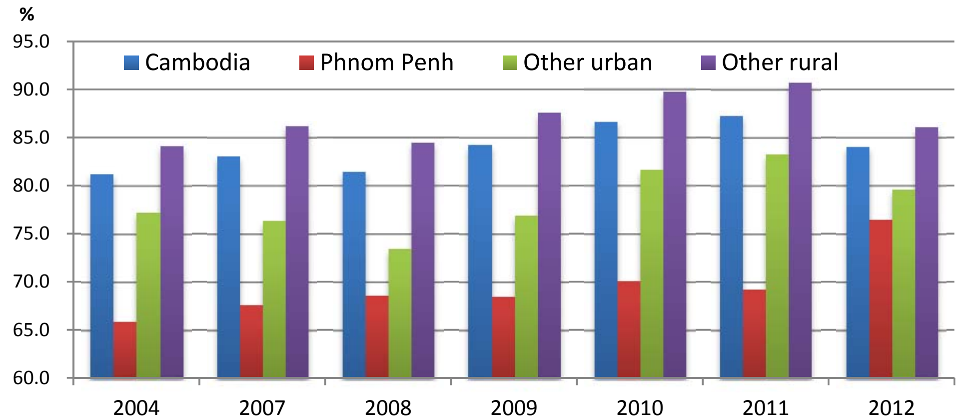
Figure 6. Cambodia's employment rate



Source: CSES, National Institute of Statistics, Ministry of Planning

Employment in the informal sector comprises self-employed and unpaid family workers.[13] Self-employment increased from 38.5 per cent in 2004 to 55.1 per cent of the total employed population in 2012, while unpaid family workers decreased from 37 per cent to only 9 per cent. As the labour market has expanded, people have been leaving their families to find work.

Figure 7. Employment rate by area



Source: CSES, National Institute of Statistics, Ministry of Planning

Between 2004 and 2012, the overall employment rate in Cambodia rose only slightly.[14] The employment rate is highest in rural areas, where agriculture accounts for most jobs, but is increasing more rapidly in urban areas, where industry and services are hiring more workers.

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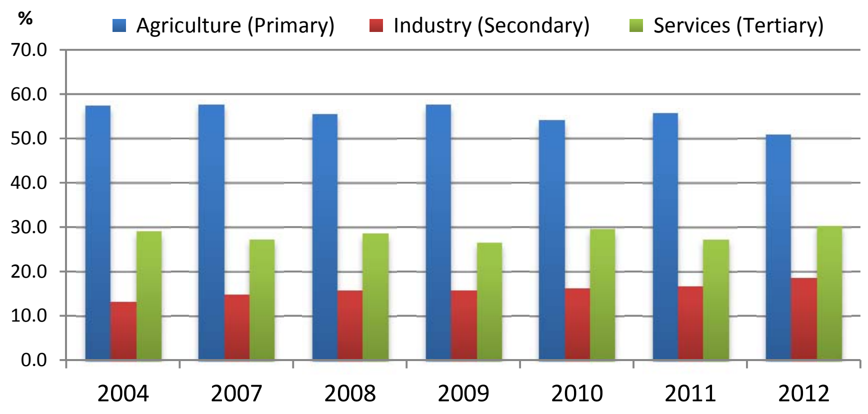
[13] Source: CSES data.
[14] CSES data.

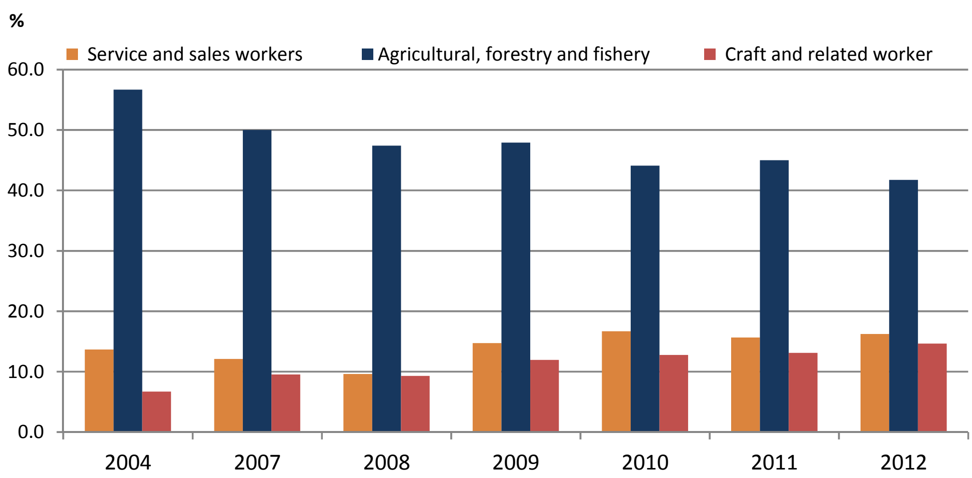
Figure 8. Employment rate by sector



Source: CSES, National Institute of Statistics, Ministry of Planning

Cambodia is still a predominantly rural and agricultural society. The vast majority of the population belong to households whose workers are self-employed in agriculture. The standard of living for these families depends on their land and livestock, their tools for fishing, their equipment for forestry and construction, and their ability to earn income in the informal sector.

Figure 9. Employment rate by dominant occupation



Source: CSES, National Institute of Statistics, Ministry of Planning

1.3. National development policy and economic diversification

The Government plans to promote growth and employment by diversifying agriculture[15] and the range of industries in its manufacturing sectors.

In agriculture, the Government has introduced the "Policy on the promotion of paddy production and rice exports" and the "Cambodia Natural Rubber Development Strategy 2011-2020". The implementation of these policies has contributed to remarkable improvements in the agricultural sector such as increased yields averaging 5 per cent during 2008-2012. Rice yields increased from 7.17 million metric tons to 9.31 metric tons. Diversification increased the area of other crops under cultivation such as corn, cassava, sugar cane, cashew nut, and pepper, from 210,000 ha in 2008 to 770,000 ha in 2012[16]. However, the low quality of agricultural products and the technology used in farming impede development.

In the manufacturing sector, the primary focus of Cambodia's development strategy, the Government is introducing its "Industrial Development Policy" to promote the diversification of the industrial base towards the production of more valuable products.[17] These include assembly, electronics and spare-parts, agro-processing and other manufacturing industries. The Government will continue to attract domestic and foreign private investment by improving Cambodia's business climate and its infrastructure, by promoting industrial diversification, upgrading small and medium-sized enterprises (SMEs)[18], modernizing enterprises, strengthening the regulatory framework, developing special economic zones and facilitating trade, expanding access to international markets and strengthening public-private sector partnership (PPP) arrangements.

In particular, this sector should be diversified and transformed into light manufacturing because this will provide more jobs for Cambodia. Light manufacturing can also boost growth in the agricultural sector because of demand for agricultural products using crops and other inputs r. According to Dr Heng Dyna, President of the Cambodia Economic Association (CEA), that sector was going to be the main driver of Cambodia's economic growth in the future. It would produce more valuable goods and foster more investment, especially in research and development. On the question why the manufacturing sector should be promoted, Mr Hay Sovuthea, senior economist at SNEC said that manufacturing sector growth would be followed by growth in the financial sector (banking and insurance), shipping companies, restaurants, and other services industries. However, manufacturing would still be the sector providing more employment opportunities for Cambodians.

The Government's policy seeks to promote political, financial and macroeconomic stability as well as a favourable environment for investment. The Government plans to diversify Cambodia's economy so that it is less vulnerable to external risks.

[15] The promotion of agriculture is very important for poverty reduction in Cambodia since around 80 per cent of the population is in the rural area and around 51 per cent of the total employed population works in the agricultural sector. Therefore, the improvements agriculture will contribute much to poverty reduction.
[16] Rectangular Strategy Phase III.
[17] Rectangular Strategy Phase III.
[18] The definition proposed by the SME sub-committee in the Small and Medium-Sized Enterprise Development Framework of 2005, small enterprises are those having net assets of USD 50,000 to USD 250,000, excluding land and employing 11 to 50 persons while medium-sized enterprises are those having assets of USD 250,000 to USD 500,000, excluding land and employing 51 to 100 persons (ADB, 2014).

Box I

Perceptions of economic diversification from the interviews

- Tourism: it is also very important to further strengthen this sector due to its important linkages with other sectors. When this sector grows, it will induce demand for supplies of local products such as agricultural and other light manufacturing products (food, towels and other local durable goods).

Commercial bank officials claimed that the development of SMEs was hampered lack of access to finance. From their perspective, the following could improve financial access:

- The Government should give secure land title to people who legally own land.
- The law on business registration of SMEs should be enforced.
- Business Associations should play a role in training their members to keep proper accounting and financial records.
- The Government should facilitate and provide incentives for SMEs to register and simplify the application procedure.
- Auditing of private companies should be enforced to ensure reliable information for banks to analyse.

1.4. Challenges to economic diversification

As highlighted in the Rectangular Strategy Phase III, major obstacles to achieving economic diversification remain. These challenges are as follows:

1. The Cambodian economy is still highly dollarized, which limits monetary policy.

2. Access to finance is still very limited.

3. The legal framework is not comprehensive and hinders public confidence as well as the expansion of SMEs. Governance is also cited as hindering the diversification process, e.g. administrative red tape and informal payments as well as lack of laws to protect and promote private investment.

4. Cambodia has an underdeveloped and inadequate transport and logistics system. It lacks effective management to repair and maintain its road networks. Transport costs are high compared to those in neighbouring countries. Furthermore, Cambodia's transportation systems are not adequately connected with regional and international transport systems.

5. The cost of electricity is high compared to that in neighbouring countries. Although Cambodia has made considerable progress in ensuring a reliable supply of electricity in its cities, people in rural areas lack sufficient access.

6. Cambodia lags behind other countries in developing skilled and high quality workers. The supply of skilled labour is probably not adequate to support the current pace of domestic economic growth. In addition, Cambodian labour is not sufficiently mobile, worker's rights need to be improved, and working conditions for local and foreign workers require further development. Reasons suggested for the inadequacy of skilled labour include:

a. The quality of education still does not respond to labour market needs and there is still a high drop-out rate.
b. The lack of sufficient vocational training coupled with the low quality of formal education creates a mismatch between the skills required by employers and the skills possessed by workers. Cambodia lacks good policies to prepare workers for good jobs.
c. The information mismatch between labour demand and labour supply. There is lack of means to transmit information about job opportunities to job seekers.
d. Cambodia lacks ways of resolving disputes between employers and employees, especially concerning wages and working conditions.
e. Too many skilled workers emigrate to earn more generous wages.

7. Cambodia has a narrowly-based industrial structure that lacks auxiliary industries to support the main industries. Its industries produce low value output and lack the modern technology required to achieve high productivity.

8. There is no clear strategy to attract FDI and no proper industrial development plan.

2. Monetary policy, economic growth and employment in the context of dollarization

2.1. The role of monetary policy

There is abundant literature on the roles of central banks in achieving the objectives of price stability as well as growth and employment[19]. Conventional wisdom has it, the primary policy is monetary policy, which controls money supply in the economy. A central bank expands or contracts its supply of base money to affect macroeconomic variables and ultimately achieve its desired goals including achieving inflation targets, economic growth and employment creation.

By expanding money supply more rapidly than usual, the credit market will ease, interests rate will decrease and induce more borrowing and spending for investment and consumption, thereby boosting growth and employment. However, at the same time, the increased spending also pushes up price levels and leads to inflationary pressure. Conversely, if central banks contract the money supply, interest rates will be higher, causing a slowdown in borrowing and spending which leads to lower growth and employment, while at same time can lowering the inflation rate and controlling price levels. In addition, monetary policy also has an effect on exports and imports through the exchange rate channel and shapes people's expectation over future inflation and growth prospects, as well as affecting asset prices through interest rate changes.

To conduct monetary policy, central banks typically use three tools – open market operation, discount window, and reserve requirement rate. With open market operation, the central bank can exercise control over the monetary base by selling or buying government or its own securities in the open market, thus affecting the level of money supply and interest rates. The discount window involves making discount loans to eligible commercial banks on a short-term basis to provide a backup source of liquidity and affecting the level of reserves in the banking system. The reserve requirement rate policy is used by the central bank to change the proportion of deposits that commercial banks are required to place as a reserve in the central bank, thus affecting amount of deposits available for lending or held as reserves.

Among these tools, open market operation is the most popular and flexible monetary policy tool and commonly used by central banks in advanced economies. It gives them complete control over the volume and extent of the measure as they see fit, and any change or reversal can be done quickly without administrative delays. In addition to these three common tools, central banks also employ other tools such as targeted credit policy, capital requirement, exchange rate intervention, and so on, depending on country-specific factors and the desired outcome.

Despite the common tools that central banks have in their armoury, the way in which monetary policy is used and its main goals might differ across countries. In developed countries, monetary policy is normally confined to a narrow mandate, price stability, as an exclusive and primary objective, while in developing countries monetary policy often aims to achieve multiple objectives (Bhattacharyya, 2012). Different goals or mandates of central

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[19] Brimmer (1971), Chandavarkar (1987), Epstein (2005), Epstein (2007), Mujeri (2008), Ortiz (2009), Hammond, Kanbur and Prasad, (2009), Goodhart (2010), Anwar and Islam (2011), Bhattacharyya (2012) and many others.

banks can have different implications on how they contribute to economic growth and employment.

For a central bank whose mandate focuses on price and financial stability, their contribution is made indirectly by addressing price and wage uncertainty. A commitment to price stability allows wage claims to be set with certainty regarding the future cost of living and economic agents can make well-informed consumption and investment decisions in a stable price environment, and thus allocate resources more efficiently (Bhattacharyya, 2012). Price stability is also a necessary, though not sufficient, component of financial stability and the smooth functioning of financial system. Price and financial stability is also an important determinant in attracting the domestic and foreign investment crucial for economic development and employment creation. Fluctuations in price levels can cause social problems and industrial disputes. Moreover, fluctuations in price levels can be perceived as macroeconomic instability and render the economy vulnerable to shocks, which can in turn lead to fluctuations in investment, output and employment.

The drive to limit the central banks' mandate to price and financial stability alone stems from the view that overall best practice is to concentrate on price stability as an exclusive target of monetary policy rather than pursuing multiple objectives (IMF, 2006). This view is widely accepted on the assumption that once stability is achieved, economic growth and employment creation will follow (for example, see Epstein, 2007).

Although intuitively appealing, it is commonly argued that central banks in developing countries should play a more active role in addressing the widespread poverty, inequality, and insufficient employment opportunities (Bhattacharyya, 2012). Justification for this argument can be found in Europe and North America[20] from the end of the Second World War to the 1970s, when central banks used monetary policy to maintain low interest rates to support rapid investment and reduce the cost of servicing public debt (Goodhart, 2010). In addition, Epstein (2005) concluded that central banks should not entirely abandon development policy but rather seek an appropriate policy specific to the situation in their own country.

Studies by Ocampo (2002), Epstein, Jomo and Grabel (2003) and Bhattacharyya (2012) also concur that central banks, particularly in developing countries, should have multiple objectives, focusing on poverty reduction, employment and economic growth in addition to price and financial stability. In developing economies, orderly prioritization of objectives is not commonly established by legislation, even though price and financial stability tend to be the main central bank objectives in practice. To achieve these multiple objectives, central banks need to use monetary policy in a different manner[21] and their policies need to be closely coordinated with government policies[22] and support development plans (Lim, 2006 and Bhattacharyya, 2012). For example, where there is trade-off between inflation and

[20] Banks in Europe mostly originated from private banks supporting government activities and then became central banks later, mainly after World War II. They were extensively involved in using credit control and allocation to support the government in boosting economic growth and employment (Epstein, 2005).
[21] Lim (2006) argues that loose monetary policy alone cannot stimulate investment or growth since it will undermine financial confidence and lead to stricter financial requirements on banks. He suggested using capital management to stabilize exchange rates.
[22] The example of policy coordination is that many successful developing economies with open capital markets can avoid the danger of capital flight through the use of various capital management techniques and help to escape 'trilemma' problems (Epstein, 2007). The trilemma (the "impossible trinity") in international economics states that it is impossible to have all three of the following at the same time: 1) a fixed exchange rate, 2) free capital movement (absence of capital controls), and 3) an independent monetary policy.

employment, central banks will actively promote employment, unlike central banks whose sole mandate is price stability.

Furthermore, to align themselves with development plans, central banks actively direct credit to specific industries or areas by setting interest rate controls, lending quotas for commercial banks and lending schemes for particular purposes. Similarly, as described by Epstein (2005), central banks, both in the developed and developing world, use the credit allocation technique to help promote economic growth by supporting priority sectors and institutions and channelling real resources accordingly[23]. Programmes to direct credit to underdeveloped industries and regions have been controversial. Chandavarkar, (1987) has indicated that in many industrialized economies, including Japan, South Korea, Italy, the Netherlands, Sweden, the United States, and West Germany, direct credit was granted to underdeveloped industries and regions as well as to small businesses during their rapid industrialization phase, but some of them ceased to provide such credit after the creation of central banks. Epstein (2005) showed that most central banks used credit allocation and control techniques to support the government and their own objectives in boosting economic growth while Brimmer (1971) also claimed that the effectiveness of those policies was mixed because there was trade-off between the development roles and stability roles of the central banks themselves.

The tools used included the following: providing capital to specific development institutions; purchasing their securities and equities; using differential discount rates to allocate credit to capital development projects; establishing ceilings on low priority activities; imposing differential reserve requirements to influence the allocation of credit; and using import deposit requirements (primarily intended to deal with balance of payments difficulties) to influence the allocation of bank credit (Brimmer, 1971). However, many developing countries have failed to replicate this policy due to governance issues which cause poor allocation of credits and high leakage rates (Bhattacharyya, 2012), although Amsden (2004) claimed that the success of the industrialization of the others after World War II was mainly due to the role of finance[24].

Summing up, there have been many examples of central banks working successfully in coordination with their respective governments to achieve economic and social development goals through the use of various monetary instruments, including credit subsidies, capital controls, asset-based reserve requirements, and interest rate ceilings, in addition to maintaining price and financial stability based on country specificities. Today, after the global financial crisis, there has been widespread policy coordination, covering monetary policy, financial sector policy and fiscal policy, where many central banks now are employing monetary policy targets that take into account the impacts on fiscal policy and the financial sector, including the use of macro-prudential policies.

2.2. The role of financial sector policy

A substantial literature on finance and economic growth discusses the extent to which financial systems can promote growth. Banks can: i) provide credit to the economy, ii)

[23] What is important here is that credit control and credit allocation techniques were extensively used by central banks to promote growth. However, there are also disadvantages in terms of banks' competitiveness, as pointed out by (Bhattacharyya, 2012), since s it can decrease the profitability of commercial banks and reduce the role of market economics.
[24] Development Bank played the main role in directing long-term credit to targeted industries (Epstein, 2005).

collect deposits from the public, iii) provide the means of payment of customers, and iv) process payments.

Apart from maintaining price stability, central banks in many countries also have a responsibility as regulator and supervisor over the financial system[25] or at least the banking system. In this role, central banks can contribute to economic growth and employment through the positive interlinkage of financial sector stability,[26] development and economic growth and employment.

Many empirical studies have examined the impact of the size of financial system on economic growth. Almost all of them, using both macro and micro data, find that financial development enhances growth by facilitating productive investment and the development of human capital (Pelgrin et al., 2002). Moreover, the impact is evident in both developed and developing countries.

Conceptually, a sound and efficient financial system channels funds from savers to investors.[27] This allocates capital efficiently, boosting the accumulation of capital and economic growth.[28] Well-functioning financial systems can also improve people's wellbeing by allowing them to relax constraints and frontload some of their consumption in the expectation of higher incomes in the future.

This underlines central banks' important role in ensuring sound development and stability of the financial system, which may be achieved by regulation and supervision, as well as maintaining price stability. Regulation and supervision of the banking system promotes strong financial institutions, which in turn supports financial stability and economic development (Serres, Kobayakawa, Slok and Vartia, 2006). It should also support sound financial markets, protect consumers and investors, and minimize crises.

These multiple objectives sometimes conflict. Stringent regulation, ranging from capital requirements and deposit insurance to interest rate ceilings and branching controls, has undermined the efficiency of the financial system[29]. In many developed countries, central banks have sought a trade-off between prudence and efficiency. Thus, progressive deregulation has reduced the cost of intermediation and enhanced efficiency. The current crisis has provided clear evidence that a well-functioning financial system supports growth and employment (Sinha, 2011). Financial intermediaries are most effective in countries with strong rights for creditors, enforcement of contracts and sound accounting practices,[30] (Serres et al, 2006).

Indeed, the failure of regulation and supervision was a principal cause of the current crisis. Central banks are therefore paying much more attention to the ways in which they regulate and supervise banks. In emergencies, central banks support their banking systems by acting as lenders of last resort. This was intended to be the most important role of the Federal Reserve when it was created, to avoid financial panic and thus prevent bank failures from

[25]This paper intentionally focuses only on banking system stability and development since Cambodia's financial system was dominated by the banks and the stock market, and other financial aspects are at a very early stage of development.

[26] "A financial system is in a range of stability whenever it is capable of facilitating (rather than impeding) the performance of an economy, and of dissipating financial imbalances that arise endogenously or as a result of significant adverse and unanticipated events" (Schinasi, 2004).

[27] This implies that both the stability and the development of the financial system can contribute to economic growth.

[28] King and Levine (1993).

[29] Serres, et al. (2006).

[30] Levine, Loayza and Beck (2000).

spinning out of control. As the lender of last resort, central banks provide liquidity to banks when no one else will, to avoid financial panics that can severely disrupt financial intermediation and thus damage the economy.

2.3. The role of payments systems

Some central banks around the world are responsible for oversight and development of national payments systems. Payments systems, which allow transactions to be completed safely and in a timely manner, are a vital part of a country's financial infrastructure. A safe and efficient payments system is essential to support the day-to-day business of an economy and to settle transactions in its financial markets. Its failure could contribute to systemic crisis and transmit financial shocks to the financial system.

Payments systems not only play an important role in the implementation of monetary policy and the financial system but also promote economic growth. An efficient payments system can reduce costs and make it convenient for consumers and firms to access and transfer money and thus increase returns to their economic activities (Hildebrand, 2007). According to the World Bank, in developing countries, a low-cost and safe payments system is much more useful and meaningful when it covers people in rural areas who need payment and remittance services.

Quantitatively, a study by Moody's Analytics (2013) indicated that a modern payments system supports growth and employment. For example, it tested the impact of electronic card payments using 56 countries that generate 93 per cent of the world's GDP over a five-year span from 2008 to 2013. It found that greater use of electronic payments added USD 983 billion to the GDP of the sample countries, raised consumption by 0.7 per cent on average, adding 0.17 per cent to GDP growth. This additional growth is equivalent to creating 1.9 million jobs during the period. The study also suggests that, looking forward, a one per cent increase in the use of credit cards would increase consumption by 0.056 per cent and GDP by 0.032 per cent, respectively. Electronic payments contribute more to emerging market countries, boosting GDP by 0.8 per cent, than to developed countries, a 0.3 per cent increase in GDP. Against this background, developing an efficient, secure and reliable payments system is another contribution that central banks can make to economic growth and employment generation.

2.4. The role of financial inclusion

Financial inclusion is defined variously by different institutions and researchers. The United |Nations (2006) defined financial inclusion as the provision of credit to all "bankable individuals and firms, insurance to all insurable individuals and firms; savings and payment services for everyone." According to Hanning and Jansen (2010), financial inclusion is the act of bringing the "unbanked" population into the formal financial system so as to allow them the use of financial services. Similarly, Khan (2011) defined financial inclusion as the process of ensuring access to financial services and timely and adequate credit where needed by vulnerable and low-income groups at an affordable cost. It primarily represents access to a bank account backed by deposit insurance, access to affordable credit and the payments system. The IMF (2014) refers to financial inclusion as an economic state where individuals and firms are not denied access to basic financial services based on grounds other than efficiency criteria. Although the definition varies, the common theme is the expansion of the scope of financial services provision to include the poor in an efficient manner.

There is increasing evidence that financial inclusion has impacts on both aggregate growth and individual wellbeing. At macroeconomic level, Beck and de la Torre (2006), Beck, Demirguc-Kunt, Laeven and Levine (2004) and Honohan (2004) suggest that allocating resources to new investors promotes innovation while, according to de la Torre, Gozzi and Schmukler (2007), access to finance for new entrepreneurs is an important driving factor linking finance to growth. The importance of innovation, according to Schumpeter's 1942 theory of "creative destruction", and the focus on entrepreneurship in financing it, increases economic activities and job creation by promoting new entrepreneurs who produce new products in the market and thus create demand. Therefore, promoting financial inclusion means allocating resources to newcomers who in turn promote innovation and new entrepreneurs in a continuing cycle.

In addition to growth, financial development is also found to be a factor contributing to the reduction in income inequality and poverty alleviation[31]. The findings from the studies by Banerjee, Duflo, Glennerster and Kinnan (2013), Pande and Burgess (2005) and Gine and Townsend (2003) showed that broader financial systems can generate potential positive effects on investment and economic growth by lowering the cost of branch expansion of financial institutions.

At microeconomic level, financial inclusion helps to expand individual businesses and profits, increase household consumption and consumption of durable goods which in turn raises living standards and moving out of poverty. Recent research in South Africa showed that access to credit improved wellbeing while loans to customers were also profitable (Hanning and Jansen, 2010). In addition, loans from well-regulated financial institutions such as microfinance instutions have had positive impacts on the quality of lives of poor families (Zeller and Sharma, 1998 and Singh and Yadav, 2012) by building up their assets, increasing incomes and reducing their vulnerability to economic stress. According to the World Bank (South Africa Economic Update, 2013) in South Africa, financial inclusion could contribute to the reduction of poverty and inequality and even stimulate job creation.

Driving financial inclusion further requires input from central banks. According to Hanning (2013), there are some smart solutions to financial inclusion that have been used successfully in developing and emerging market countries. They include doubling the number of access points (bank branches and ATMs) in the Philippines, and the development of extensive agent banking, mobile payment systems and tiered know-your-customer requirements to facilitate the opening of basic bank accounts in Nigeria. The Central Bank of Nigeria (2012), and Hanning (2013) suggest further that financial literacy, consumer protection, aggressive cashless programmes and the implementation of the Micro, Small and Medium Enterprises Development Fund can further improve access to financial services in future years by the underserved.

In particular, the international experiences described above show that six ways of expanding financial inclusion have proved effective : agent banking, mobile payments, diversification of providers, state bank reforms, consumer protection and financial identity policies. All of these were initiated by the central bank, as discussed by Gray (2006), which allowed for the expansion of banking institutions and financial services through regulatory and supervisory support. Similarly, in the Phillippines, the Central Bank was actively involved in promoting microfinance as an agent of financial inclusion using three main approaches centered on the development of a microfinance-friendly policy and regulatory environment, microfinance capacity-building within the banking sector, and promotion and advocacy (ABAC, 2008). Similarly, the Central Bank of Nigeria has stated that increasing financial inclusion helps it to achieve its core mandates (CBN, 2012). The CBN's National

[31] Beck, Demirguc-Kunt, Laeven and Levine in *Finance, Firm Size, and Growth*, 2008.

Strategy of Financial Inclusion states that promotion of a sound financial system can be achieved by increasing financial inclusion through robust domestic savings which are not prone to volatility in the face of external shocks. Services needed by the market but which financial institutions cannot provide should be provided by the central bank. The expansion of microfinance institutions, by offering new products and services to customers, should be licensed and supervised closely by the Central Bank, which would also set interest rates that are profitable for them. This would ensure financial stability and sound growth of financial inclusion (Gray, 2006).

2.5. Policy constraints in the context of dollarization

In highly dollarized economies, monetary policy is less effective in promoting price stability, economic growth or employment (Sahay and Vegh, 1995; Calvo and Vegh, 1996). When people shift a large share of their funds between the dollar and local currencies[32] the demand for the local currency and the exchange rate can become more volatile[33]. Large shifts between local and foreign currency assets have a similar effect.

In dollarized economies, money transmission is also weak, because the foreign currency component of the money supply cannot be measured and can hardly be managed by the central bank. The higher the degree of dollarization[34], the bigger the components of foreign currency component in the money supply[35], and thus less room for central banks to influence the money supply and interest rate by adjusting the domestic currency components of monetary base. The constraints on managing money supply clearly undermine and complicate the ability of central banks to conduct monetary policy effectively.

Another implication of dollarization is that it restricts central banks' ability to serve as lender of last resort. In a non-dollarized economy, central banks always have an ability to print money to provide emergency loans to banks and financial institutions. In highly dollarized economies, where the deposits in the banks are mainly placed in foreign currency, central banks have no authority to print foreign currency to provide loans. In that case, their ability as lender of last resort is limited to their holdings of foreign exchange assets. In this case, they must arrange external lines of credit and swaps with other central banks.

In the context of monetary policy, the constraints posed by dollarization have hampered central banks in responding effectively to undesirable economic consequences and achieving sustainable economic growth and employment. Some central banks have attempted or are currently attempting to de-dollarize their economy to restore important monetary policy tools.

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[30]Calvo and Vegh (1996): Currency substitution is a form of dollarization, representing the situation of a foreign currency being used alongside the domestic currency as means of exchange, while asset substitution represents the situation where a foreign currency serves as a store of value alongside the domestic currency.

[33] Sahay and Vegh (1995), in the study on dollarization in transition economies, found that the loss of monetary policy effectiveness left central banks with the choice of anchoring the exchange rate rather than controlling inflation and also that targeting a monetary aggregate in a small, very open and highly dollarized economy is not a good policy choice.

[34] Dollarization refers to a situation when a foreign currency is used as a unit of account, store of value and medium of exchange in a country in parallel with the local currency or used completely instead of the local currency (Feige, Sosic, Faulend, and Sonje, 2002). According to Balino, Bennett, and Borensztein (1999 and 2003), dollarization is a phenomenon in which residents of a country hold a majority of their financial and monetary assets in foreign currency, where foreign currency is not the legal tender.

[35] Money supply in dollarized economies consists of currency in circulation and deposits in both local currency and foreign currency. In many developing countries, where financial intermediation is not yet well developed, currency in circulation is large. This includes a large proportion of foreign currency which is difficult to measure.

3. The National Bank of Cambodia as an agent of economic diversification and employment creation

3.1. Missions and functions of the National Bank of Cambodia

Since its transformation from a mono[36] to a two-tier banking system in the late 1990s, the NBC has had a clear mandate: "the primary mission of the National Bank of Cambodia is to determine and direct monetary policy aimed at maintaining price stability in order to facilitate economic development within the framework of the country's economic and financial policy"[37]. Although the NBC does not define price stability with a numerical target, it tries to maintain the inflation rate at less than 5 per cent. There is no explicit mandate for the NBC to promote employment. Nevertheless, it coordinates its monetary policy with fiscal policy and other government policies. Its management of the exchange rate between the riel and the US dollar has promoted macroeconomic stability. In turn, this stability could also reduce interest rates in Cambodia due to lower monetary risk, exchange rate risk and more stable growth.

The NBC supervises and regulates Cambodia's banking system[38], which represents more than 90 per cent of the assets of the financial system. In this regard, it plays an important role in promoting financial stability. It also maintains the payments system[39], which handles both domestic and foreign transactions. In a cash based economy like Cambodia, the NBC has developed and modernized the payments system to facilitate secure and efficient economic and financial transactions. It also promotes financial inclusion, providing the opportunity to those who need funds or other financial services to improve their business activities or wellbeing.

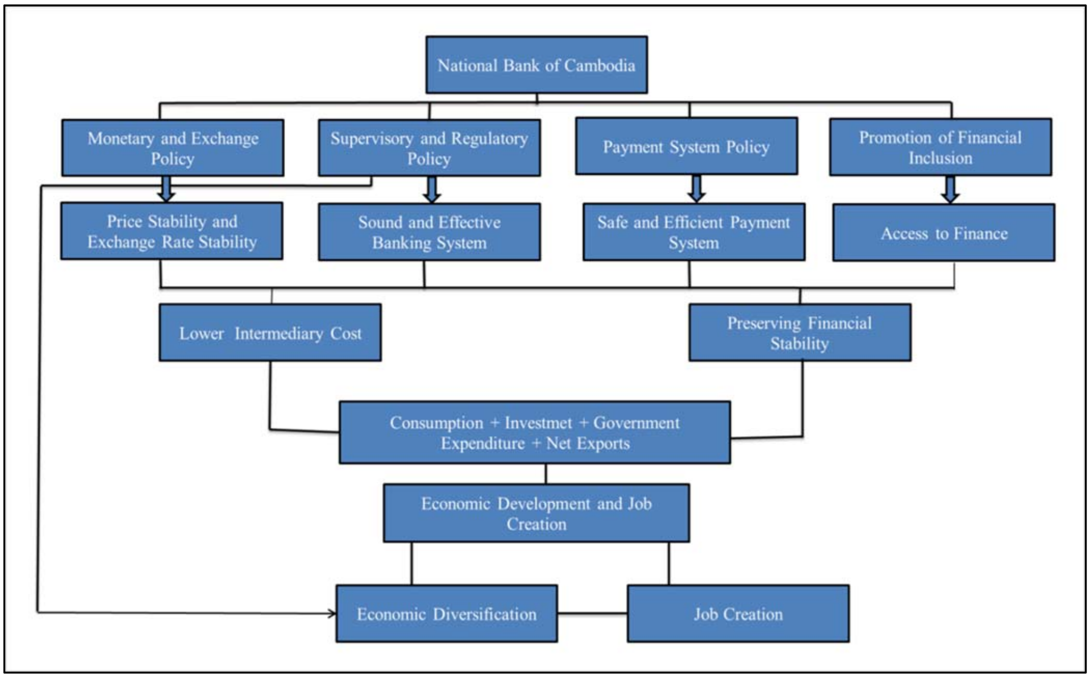
In order to fulfil its mission, the National Bank of Cambodia has the following important functions and duties:

- To determine monetary policy objectives, in consultation with the Government and in the framework of the country's economic and financial policy. To realize these objectives, the National Bank of Cambodia formulates, implements and monitors monetary[40] and exchange rate policies.
- To issue and withdraw licences, regulate and supervise banks and financial institutions and other relevant establishments such as auditors and liquidators. The NBC evaluates and licenses banking and other financial services operations by balancing economic growth and financial stability. If a financial institution does not respect or cannot comply with the laws, regulations and supervisory requirements, the NBC will ultimately withdraw that institution's licence to prevent harm to the system.
- To oversee the payments system and operate interbank payments. The NBC has developed and modernized the national payments system. It clears and settles transactions between banks and financial institutions.

[36] The National Bank of Cambodia acted as the monetary authority of Cambodia while at the same time functioned as a commercial bank for the public alongside other commercial banks.
[37] Article 3 of Act on the organization and conduct of the National Bank of Cambodia, adopted in 1996.
[38] Article 7 of Act on the organization and conduct of the National Bank of Cambodia, adopted in 1996.
[39] ibid.
[40] Due to the high degree of dollarization and the pegged exchange rate, the NBC could not influence the market interest rate.

- To participate in the formation and supervision of money and financial markets. The NBC is a member of the Securities Exchange Commission of Cambodia (SECC). It is also developing the money market by introducing the Negotiable Certificate of Deposits (NCD)[41].

Figure 10. The NBC's roles in supporting economic growth and diversification and job creation



Source: Authors

[41] NCDs were launched on 9 September 2013 with the aim of promoting the development of an interbank market, secure lending in that market, and easing the management of liquidity in addition to fixed deposits by banks with the NBC. TNCDs can be denominated in both Khmer Riels and U.S. dollars.

Box II

Roles of the NBC from other perspectives

In interviews, it was suggested that the NBC could expand its role in contributing to economic diversification and employment as follows:

- According to Mr Stephen Higgins, CEO of ANZ Royal Bank, the NBC could choose alternative ways of setting policy that could affect the behaviour of banks in the light of circumstances. It could use prudential regulation to encourage banks lend to key sectors, and balance the growth of credit to various sectors in line with the Government's targeted policies. Mr. Doung Poullang, Senior Economist from the ADB, said that the more deposits the bank and MFIs could mobilize, the greater the availability of funds for lending. When they had more funds to lend, they would compete and when banks and MFIs competed with each other, the winners were the customers…".
- The NBC could set interest rates to favour targeted sectors, with caps on interest rates.
- Access to finance could be further increased by encouraging more domestic saving and reducing interest rates. The NBC has promoted the development of the Microfinance sector since 1999 (see section 3.2.3 on Financial inclusion). It could further improve the collateral system to provide more credit to the private sector.
- The effectiveness of monetary policy could be improved by de-dollarizing the economy.

3.2. Policy tools and operations of the NBC to spur economic diversification and productive employment in the context of dollarization

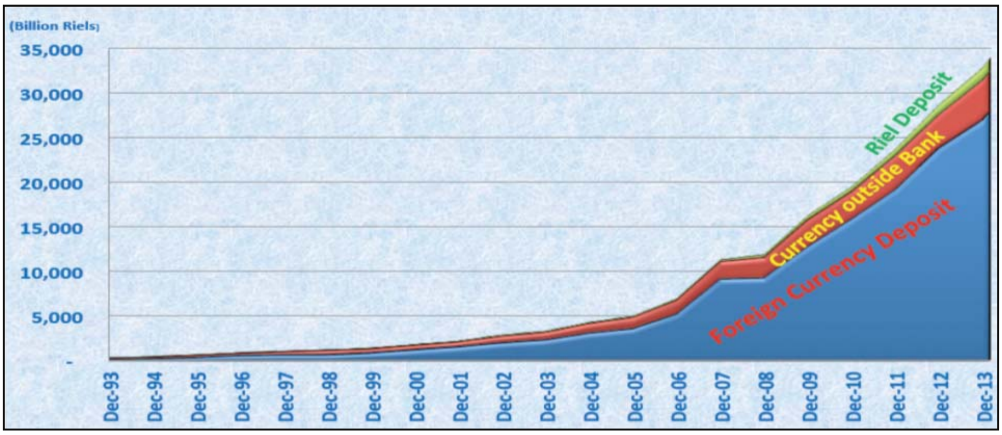
An analysis of the NBC's operations and policies might reasonably begin by describing the environment where they are implemented. Two of the main constraints for the NBC are Cambodia's high degree of dollarization and the managed exchange rate. Because Cambodia is unique in this regard, these constraints need to be carefully analysed.

Dollarization in Cambodia

Cambodia's economy has been dollarized since the early 1990s[42] and is now considered to be the most dollarized in the world. The degree of dollarization, measured both by the ratio of foreign currency deposits to GDP and foreign currency deposits to total deposits, is extremely high, over 80% and 90%, respectively. The traditional causes of dollarization, hyperinflation or macroeconomic instability, hardly explained Cambodia's case. At first glance, a static analysis of dollarization might suggest that Cambodia's dollarization is both currency substitution and asset substitution, as US dollars are widely used as a unit of account, a medium of exchange and a store of value. However, further analysis shows that the reasons for the upward trend of dollarization have nothing to do with currency substitution and asset substitution.

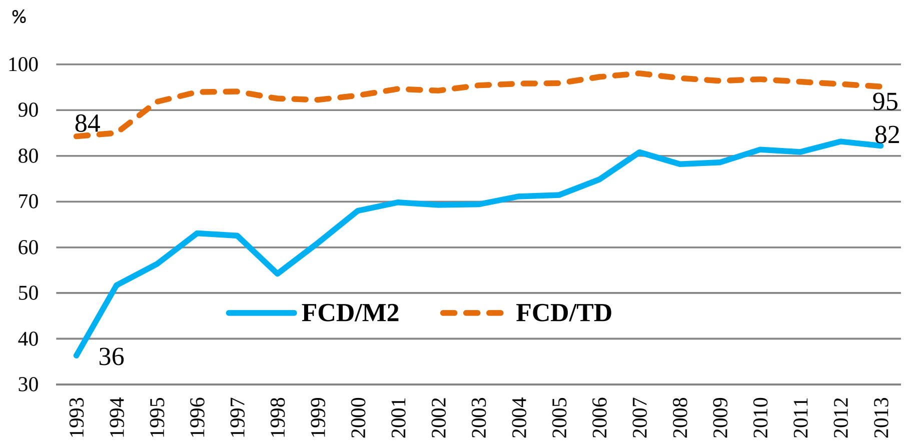
[42] It is worth noting that the US dollar has monetized Cambodia's economy which had been dominated by barter from 1979 to the late 1980s.

Figure 11. Monetary base in Cambodia



Source: National Bank of Cambodia

Figure 12. Degree of dollarization in Cambodia



Source: National Bank of Cambodia

The increase in dollarization has largely been supported by the sustainable net inflows of US dollars into Cambodia’s economy in the form of foreign aid, foreign direct investment, exports and tourism revenues (Menon, 1998 and 2008). Cambodia has achieved continuous financial account surpluses, reflecting substantial inflows of foreign exchange into its economy which have also contributed to the development of the banking sector. These foreign exchange inflows have also been used as sources of expansion of credit to the private sector in addition to domestic savings. Deposits and credits in US dollars have sharply increased since the early stage of the banking system's development, providing a more reliable currency to the economy where confidence in the local currency was low and it was already hardly used in the economic and financial transactions[43]. Using dollars has exposed the economy to seignoriage loss and risks such as liquidity risk, maturity risk, and balance sheet risks.

Recognizing these benefits and disadvantages, the Cambodian Government and the Central Bank have been taking steps to deal with dollarization. Under the Financial Sector Development Strategy 2011-2020, de-dollarization is a long-term objective while promoting the use of local currency is its short and medium-term objectives. Until now, no administrative or forced measures have been introduced to de-dollarize the economy; instead both Government and Central Bank have striven to make local currency more attractive in terms of access, quality and design of the banknotes[44], etc.

3.2.1. Monetary policy tools and operation for macroeconomic stability

Although dollarization and the pegged exchange rate have limited the effectiveness of monetary policy in Cambodia, for the last decade and a half, this has not prevented Cambodia from achieving price stability and macroeconomic stability. It has still been able to deploy its three principal policy tools of intervention in the foreign exchange market, setting reserve requirements and providing standing facilities.

Reserve requirements

The NBC has imposed reserve requirements[45] on banks and financial institutions since its inception. Reserve requirements allow it to control the money multiplier and protect depositors' money. Between 1993 and 1998, the NBC set the required reserve ratio (RRR) at only 5 per cent. The NBC raised it to 8 per cent to enhance confidence in the banking system and protect it during the Asian financial crisis.

In 2008, the NBC raised the RRR on foreign currency deposits, doubling it from 8 per cent to 16 per cent, in the wake of the global financial crisis, while the RRR in local currency remained at 8 per cent[46]. The increase in foreign currency RRR did not interrupt banks' lending because they held substantial excess reserves. In 2008, the NBC eliminated the RRR on funds borrowed from abroad to encourage banks and financial institutions to attract inflows of capital. In 2009, the NBC reduced the foreign currency RRR to 12 per cent[47],

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[43] In the 1980s, where the economy was dominated by barter, gold and rice were used respectively for large and small transactions.

[44] Policy document on Promotion of the use of Riel, 2010.

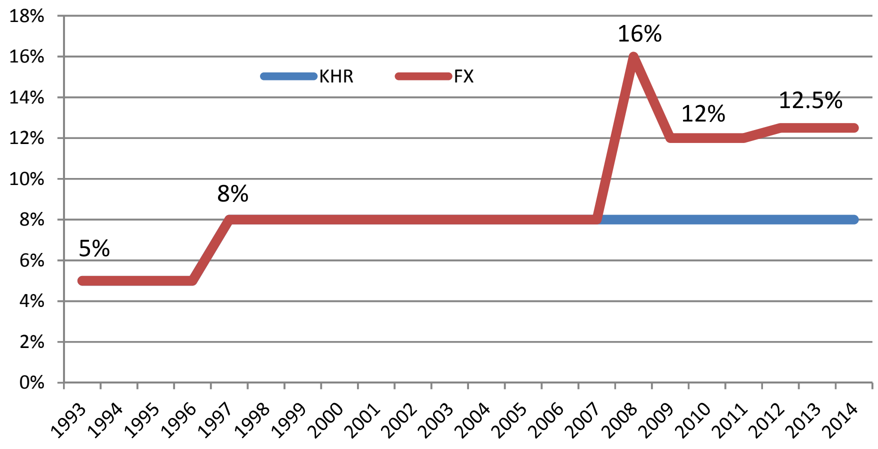
[45] According to the Order on "the maintenance of minimum reserve requirement in banks and financial institutions" , of 25 February 2009, the required reserve ratio is a ratio applied to the average deposits and other borrowings base which determines the amount of minimum reserves to be held, on average, over the corresponding maintenance period. Required reserve ratios are determined by the National Bank of Cambodia, for Riel and for foreign currencies, and are published by means of an order.

[46] In the case of reserve requirements in foreign currencies of 16%: 8% will bear interest at 0%, while the remaining 8% will bear interest at 3/4 of the one month Singapore Interbank Offered Rate (SIBOR).

[47] In the case of reserve requirements in foreign currencies of 12%: 8% will bear interest at 0%, while the remaining 4% will bear interest at 1/2 of the one month SIBOR.

raising it again in 2012, this time by only 50 basis points to 12.5 per cent[48]. The NBC maintained a relatively low RRR on riel deposits since 1998 to favour encourage its use.

Figure 13. Required Reserve Ratio



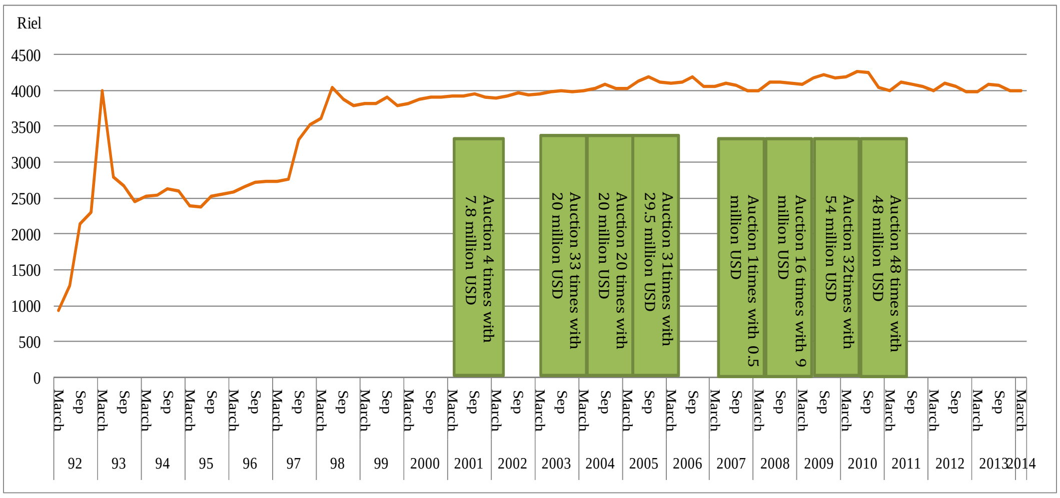
Source: National Bank of Cambodia

<u>Foreign exchange intervention</u>

In the context of Cambodia's highly dollarized economy, the pass-through effect between price and exchange rate is substantial[49]. Consequently, since the early 2000s, the NBC has managed the exchange rate for the riel, maintaining a rate close to 4,000 KHR/USD. By stabilizing the exchange rate, the NBC reduced investors' exchange rate risk[50], which in turn can reduce interest rates (see Figure 14).

[48] In the case of reserve requirements in foreign currencies of 12.5%. 8% will bear interest at 0%, while the remaining 4.5% will bear interest at 1/2 of the one month SIBOR.
[49] Though the US dollar was widely used, inflation was measured in the local currency.
[50] According to the survey of the banks (Acleda Bank)

Figure 14. Exchange rate movements in Cambodia

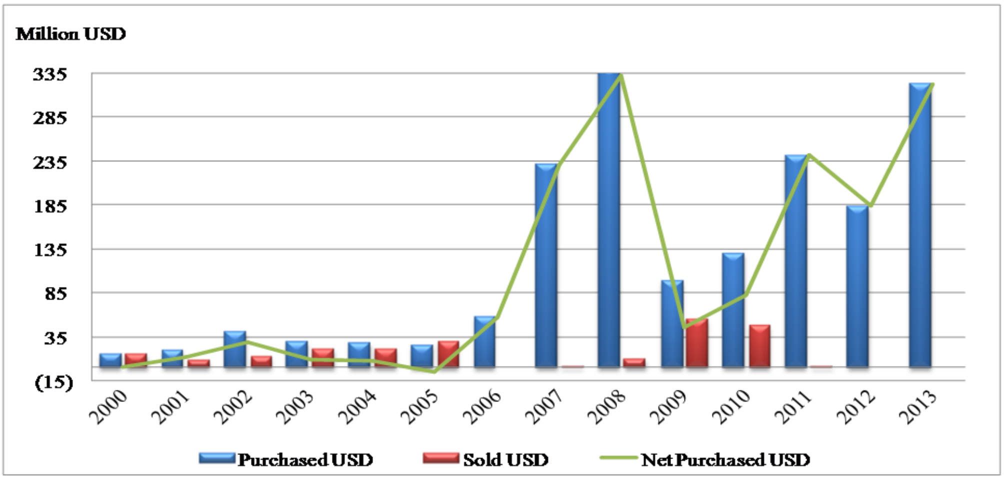


Source: National Bank of Cambodia

In order to stabilize the exchange rate under the managed float regime, the NBC intervenes in the foreign exchange market, selling US dollars when the value of Khmer Riel is too far below its target rate. The NBC has not held a US dollar auction[51] since 2011, which reflects the fact increasing demand for the local currency and so contributes to raising the amount of Khmer riel in circulation. Local currency in circulation reached an amount equivalent to 1.1 billion US dollars, compared to only 228 million US dollar equivalent a decade ago.

The stability of the riel's exchange rate has maintained the purchasing power of incomes in the local currency which is widely used in public, agricultural and rural areas[52], to protect and support the growth of economic activities in those areas.

Figure 15. US dollars purchased and sold by the NBC



[51] When the NBC announced a US dollar auction to the public, t only money changers showed any interest.
[52] According to the survey on currencies circulation in Cambodia (Khou, 2010), the local currency is widely used in the agricultural sector and in rural areas, where over two thirds of the population live.

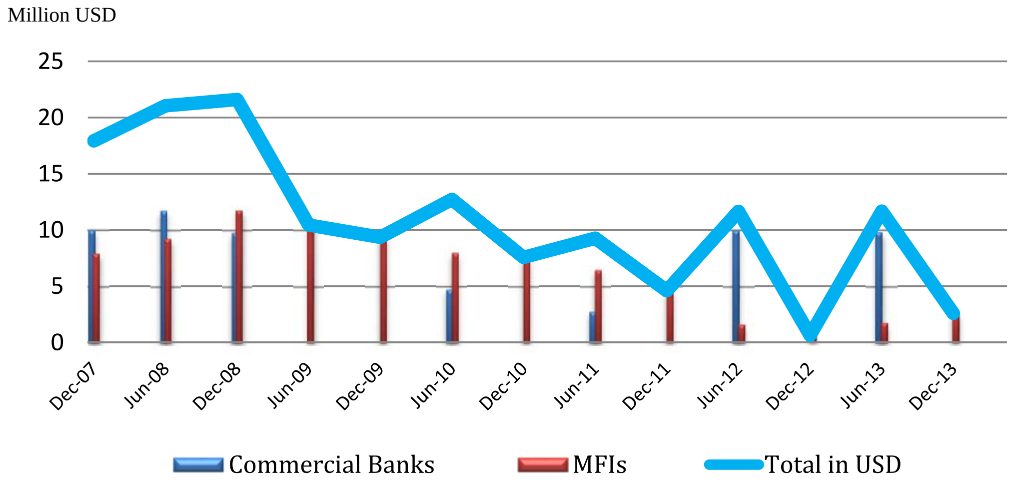
Source: National Bank of Cambodia

Lending to banks and microfinance institutions

The NBC has established two facilities, the overdraft and lending facilities, to assist banks in case of emergencies. Banks have to post eligible collateral for loans from both facilities. The NBC provides overdrafts only when banks lack sufficient reserves to meet their settlements. Usually, overdrafts have a penalty interest rate.

The lending facility is similar to short-term loans in the local currency. The NBC has retained this facility from the mono banking system. Its objective is to support activities related to the agricultural and artisanal sectors. However, this type of lending is not common for the NBC and the interest rate charged is relatively high (6 per cent per annum). Although the amount of such lending jumped in the early 2000s, the trend is generally downwards, falling to about 2 million US dollars in 2013.

Figure 16. The NBC's lending to commercial banks and MFIs



Source: National Bank of Cambodia

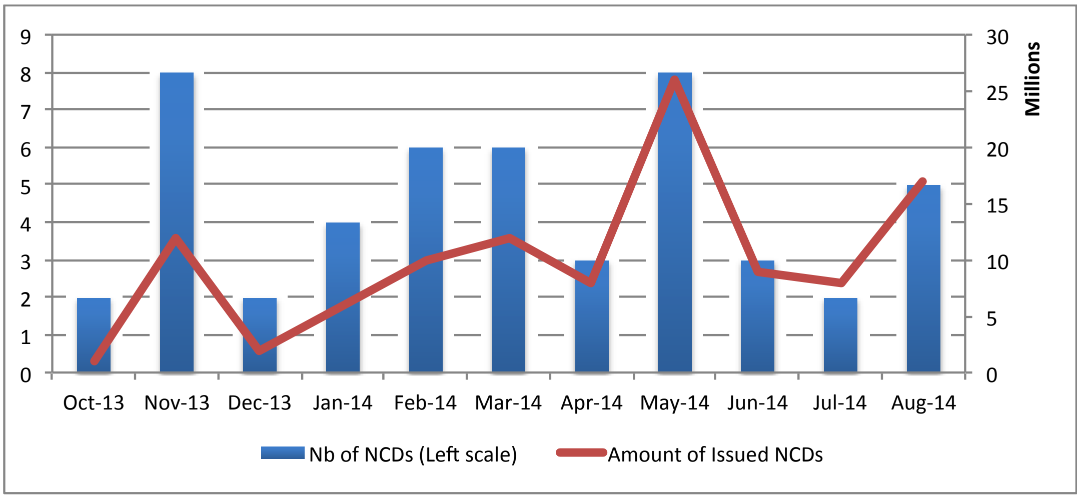
Introduction of new market-based monetary policy instrument

With the objective of enhancing the effectiveness of monetary policy based on market mechanisms and in the light of excessive liquidity in the banking system[53], as well as to introduce a new type of financial instrument (as a monetary asset) for banks and other financial institutions to help them better manage their liquidity, the NBC introduced, in the third quarter of 2013, the Negotiable Certificate of Deposits (NCD). This certificate is currently denominated in Khmer Riels or US dollars, with the minimum amount equivalent to 2,000 million riels (or 0.5 million US dollars). The NCD is interest bearing and can be traded or used as collateral by the holder to obtain liquidity from the interbank and money

[53] At the end of June 2014, excess liquidity in the banking system represented 43 per cent of the total supply of liquidity. Most of this excess liquidity is kept in the form of fixed deposits at the National Bank of Cambodia.

markets, which are currently still under-developed. NCDs are intended as a type of debt instrument, contributing to the development of the interbank and money market in Cambodia.

Figure 17. Number and amount of NCDs issued from October 2013 to August 2014



Source: National Bank of Cambodia

In September 2014, the NCD was one year old and only 51 NCDs had been subscribed for a total of USD 111 million. The issued amount is still very small and the maturity is short (one month on average) compared to that of fixed deposits and only four commercial banks have so far bought them. In addition, there is no evidence of NCD holders' transfer activities, such as selling/buying repos, pledges as collateral etc. in the secondary market. Furthermore, NCDs denominated in Khmer Riels have not yet been issued despite its higher interest rate compared to US dollars. The slow development of NCDs may be due to various factors. One is that they were launched during the national elections in July 2013 when banks and other financial institutions kept their liquidity in the form of cash or very liquid assets in order to respond to huge demand for withdrawals. Another was that NCDs were a new instrument that buyers needed time to study before investing and, thirdly, banks and financial institutions have other options in which to hold liquid assets such as fixed deposits which provided the same level of interest rate as NCD (½ LIBOR).

Recognizing these factors, the NBC introduced measures in September 2014 to make NCDs more attractive to banks and financial institutions, especially compared to fixed deposits. These measures consisted of: i) making current fixed deposits in banks and financial institutions with the NBC less attractive, by keeping interest rates unchanged and penalizing early redemption (forfeit of interest and penalty charge of KHR 500,000 per certificate), ii) increasing the interest rate on NCDs' from ½ LIBOR to ¾ LIBOR, which would then be higher than fixed deposits', iii) the NBC would buy the NCDs back before maturity at competitive prices subject to certain conditions, and (iv) the NBC would provide an online trading platform on its website, so that NCD holders could view NCD characteristics and prices.

3.2.2. Role of the banking system

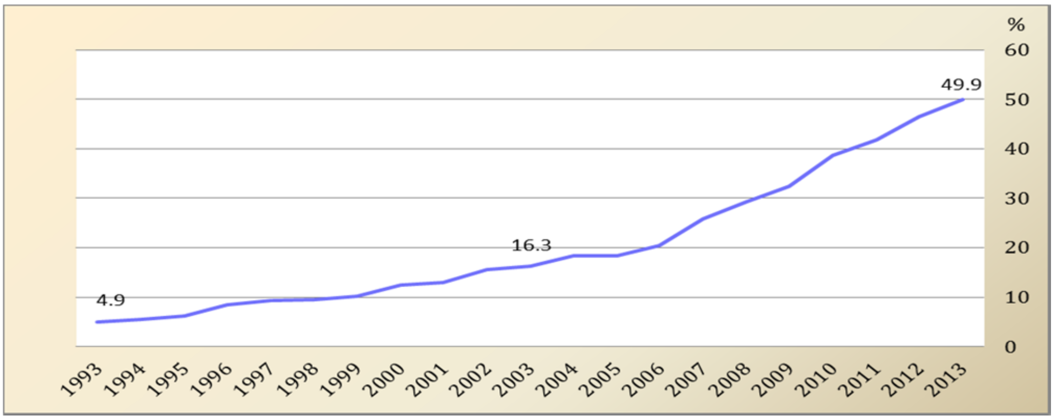
Regulation and supervision

Although the banking system[54] has developed rapidly during the last decade and a half, it is still very young. During 1999-2002, the NBC reformed its regulation and supervision to boost public confidence[55]. It marked a turning point in the history of Cambodia's banking system as confidence was gradually restored, reflecting the upward trend of assets, deposits, credits and the number of depositors and creditors in the banking system (see Figures 18 and 19 below).

Cambodia's banking system is very liberal (IMF, 2014). Foreign banks freely enter the market and may fully own domestic banks. In addition, regulations do not discriminate against foreign banks, and both foreign and domestic banks are treated equally. This policy has attracted banks and foreign funds that bring with them experience, modern technology and new financial products and services[56].

Despite its risks, dollarization has supported financial deepening in Cambodia. Measured by broad money (M2) to GDP, financial deepening has gradually increased. Its growth rate tripled between 1993 and 2003 and then tripled again through 2013. Today, it stands at about 50 per cent of GDP. This steady growth reflects the fact that more liquid money is available in the economy, and thus more opportunities for continued growth and economic diversification because of the increased ability of enterprises and households to access finance.

Figure 18. Financial deepening (M/GDP) from 1993 to 2013



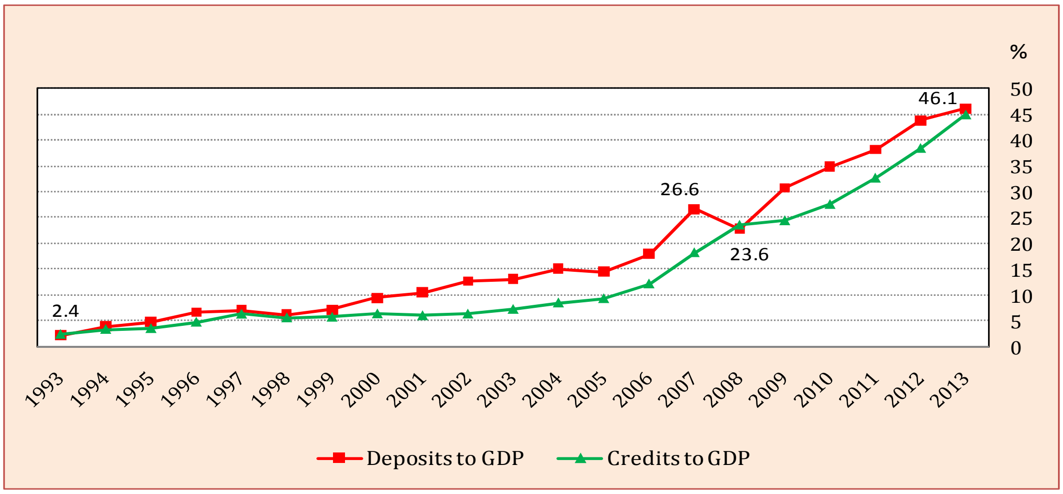
Source: National Bank of Cambodia

[54] The banking system dominates the financial sector in Cambodia. Over 90 per cent of financial sector assets are in banking.

[55] At the end of 1999, there were 31 commercial banks operating in Cambodia, of which two were state-owned, seven were branches of foreign banks and the other 22 were private banks. In April 2002, the deadline of the reform, there were 14 commercial banks and four specialized banks (specialized banks are banks exercising one of the three main activities of commercial banks: lending, collecting non-earmarked deposits from the public and providing means of payment to customers) (Khou, 2012).

[56] Currently over two-thirds of the banks in the banking system are foreign-owned.

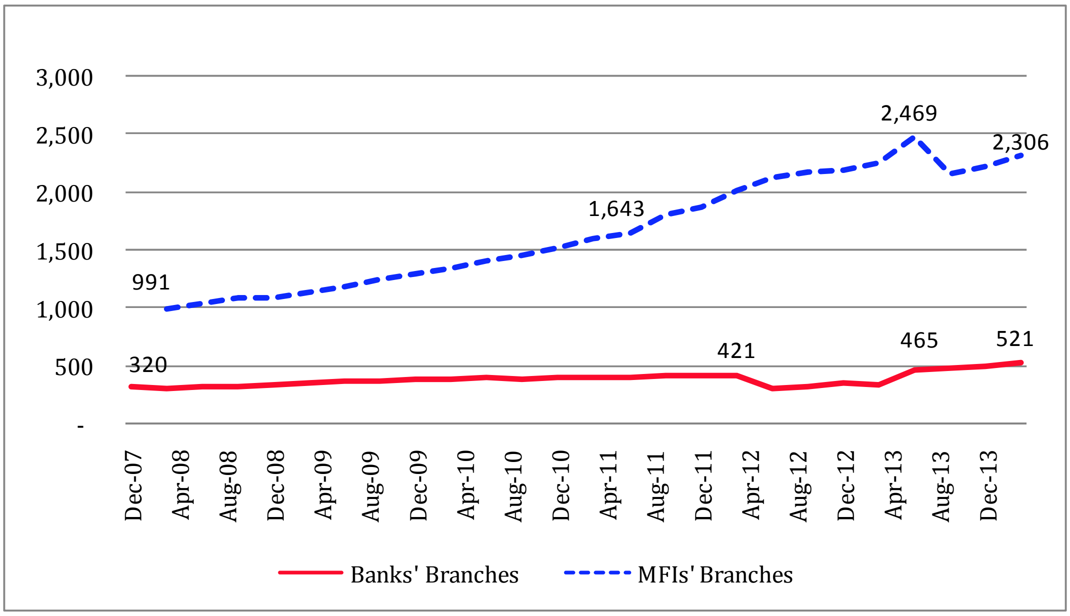
Figure 19. Ratio of credit to GDP from 1993 to 2013



Source: National Bank of Cambodia

The NBC also encouraged banks and MFIs to expand their networks throughout the country. There is no limitation on the number or size of banks or MFIs' networks. In addition, they can open branches or agencies wherever they want. As of 2013, there were 496 bank branches and 2,217 MFI branches compared to 320 bank branches and less than 1000 MFI branches respectively in 2007. The expansion of Cambodia's banking sector was matched by the number of borrowers and depositors. Although the number of borrowers to total population remains stable at around 2-3%, the number of depositors increased progressively from 5% in 2008 to 12% in 2013.

Figure 20. Number of bank and MFI branches

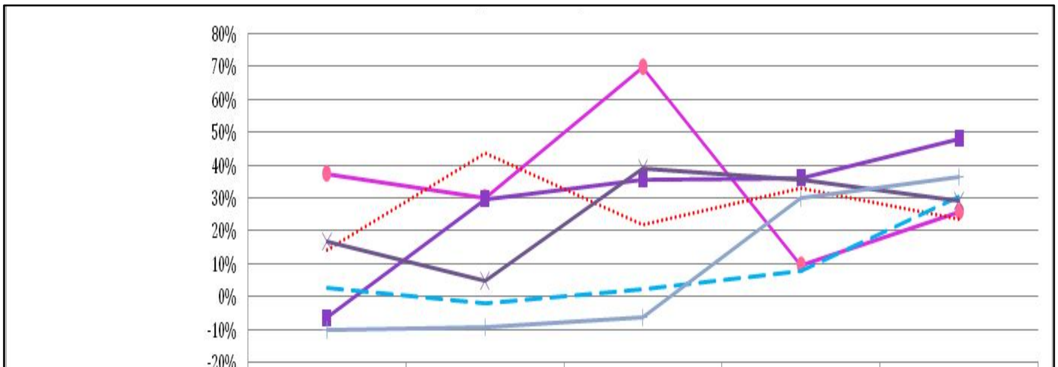


Source: National Bank of Cambodia

Credit allocation to sectors

Under these favourable conditions, credits to each sector have expanded rapidly. During the last five years, credits grew on average by 30 per cent. Credits to the agriculture sector expanded the fastest, at the rate of 42 per cent, followed by wholesale and retail trade at 32 per cent, manufacturing at 29 per cent and construction at 25 per cent. However, in the wake of the global financial crisis, recognizing the impact of the real estate sector on the financial sector and the whole economy, the NBC imposed a credit ceiling on credits to that sector[57]. This was an exceptional measure to respond to escalating risks in the sector and the ceiling was removed a few months later when banks understood the risks. The expansion of credits mostly went to the productive sectors and support for the development of the economy. Given its structure, in which the agricultural sector employed more than half of labour force, the credits to this sector were very beneficial to farming and thus in turn to the agro-industrial sector. Although the banks are free to lend for all purposes, the NBC monitors the loans to each sector in order to ensure that they manage risks properly and lend to productive sectors. The rapid expansion of credits to agriculture which mostly uses the local currency is also in line with the NBC policy of keeping the required reserve ratio low. The stabilization of the value of the local currency has clearly contributed to the increase in both lending and deposits in the local currency. The NBC's policies also continue to encourage credits to the productive sector, as well as monitoring and managing risks through macro-prudential measures, such as large exposure, liquidity ratio, solvency ratio etc.

Figure 21. Credit expansion by sector



	2009	2010	2011	2012	2013
Agriculture, Forestry and Fishing	37%	30%	70%	10%	26%
Manufacturing	-6%	30%	36%	36%	48%
Trade*	14%	44%	22%	33%	24%
Hotel & Rest.	3%	-2%	2%	8%	31%
Construction	17%	5%	39%	36%	29%
Real Estate	-10%	-9%	-6%	30%	36%

Source: Banking Supervision Department, National Bank of Cambodia

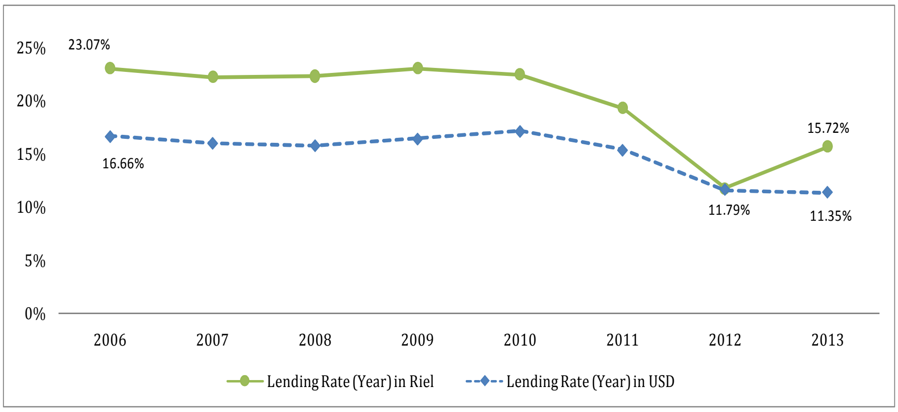
Interest rate

The growth in the number of banks and the NBC's equal treatment of banks has helped to lower the interest rate, both on USD dollar and Khmer riel loans. In addition, the NBC does not regulate interest rates on loans or deposits, but relies on market mechanisms, so

[57] Circular No. B7-08-001 on the credit ceiling on real estate, issued on 26 June 2008 by the NBC.

banks are free to determine their own rates. As a result, the interest rate on USD loans fell from 17% in the mid-2000s to 11% in 2013. At the same time, the lending rate in riel gradually decreased from 23% in 2006, to close to USD lending rate in 2012 before rising to 15.7 per cent in 2013, when one large bank that provided a large share of Khmer riel loans raised its rate after changing its policy to give preference to long-term loans (up to 5 years) to accommodate investment projects. The drop in interest rates on loans has helped to sustain investment, which is now about 20% of GDP (IMF, 2014).

Figure 22. Annual lending rate of banks in riel and USD



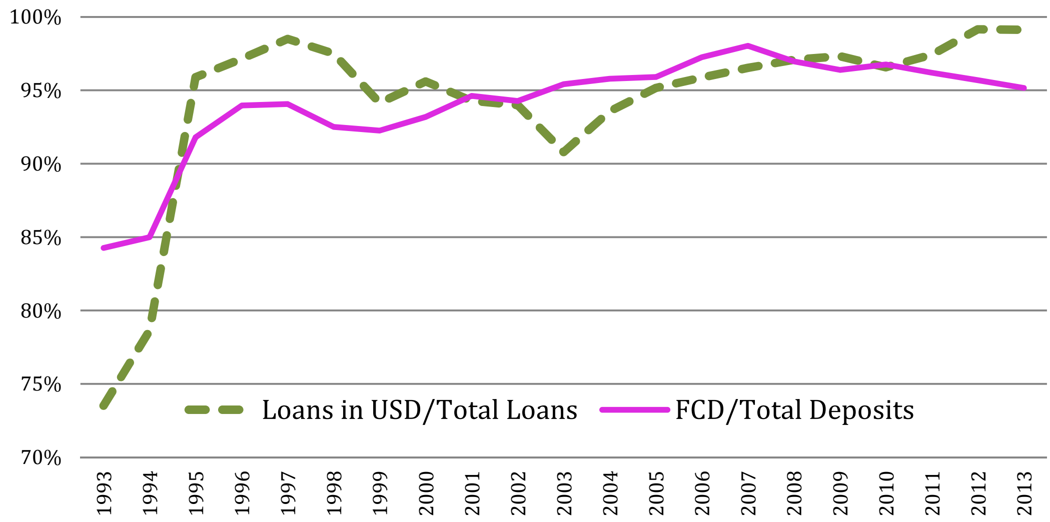
Source: Banking Supervision Department, National Bank of Cambodia

Currencies of banking operations

Cambodia's experience confirms that dollarization improves financial deepening. Allowing transactions in foreign currencies initially attracted foreign currency deposits, which would otherwise have been hoarded or placed abroad[58]. As a result, US dollar loans and deposits are now predominant in the banking system, with US dollar loans accounting for more than 90 per cent of the total. In addition, banks provide their customers with accounts in foreign currencies other than the US dollar. In some border areas, especially near the Thai border, Thai baht are accepted for deposits and loans, thereby helping to mobilize funds for investment in the region. According to interviews with banks and financial institutions as well as the traders on the Cambodia-Thai border, the use of deposits, loans and transfers in foreign currencies fosters business activity (Khou, 2012).

[58]There are three currencies used in the bank transactions in Cambodia: Khmer Riel, US dollar and Thai baht (Khou, 2012).

Figure 23. USD loans to total loans and USD deposits to total deposits in banks



Source: Banking Supervision Department, National Bank of Cambodia

As shown in the graph above, US dollar loans bear lower interest rates than loans in Khmer Riel. Consequently, loans in US dollars help develop the banking system and provide cheaper funds to the economy. Because the use of the US dollar encouraged banks to operate in Cambodia in the early 1990s[59], dollarization supports the continuing development of the financial system.

3.2.3. Financial inclusion in Cambodia

Financial inclusion supports development, especially when business is dominated by micro-enterprises as in Cambodia's case (Tanaka and Hatsukano, 2010)[60]. The NBC has fostered financial inclusion by supporting MFIs and other financial services which enable the expansion of the financial sector in Cambodia.

Development of the microfinance sector

The NBC has supervised and regulated MFIs since the early 2000s. In 2006, Cambodia's MFIs were internationally recognized for their rapid development. Their loans have reached both the poor and micro and small enterprises. Their deposits, which usually bear a higher interest rate than those offered by banks, have helped the poor to save. Today, MFI assets equal 10 per cent of bank assets. MFI loans, which equal 15 per cent of bank loans, reach 11 per cent of the population.

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[59] Gardère (2010) argued that it was the inflow of US dollars used in the United Nations operation in Cambodia in 1991-1992, as well as other US dollar inflows, that attracted foreign banks to open their business in Cambodia. That was the beginning of the development of the banking system in Cambodia.

[60] According to the NIS (2009, 2011), micro-enterprises represent over 95% of total establishments and around 60% of working people are employed in this sector, most them self-employed.

The policies of the Government and the NBC have supported the expansion of MFIs. In the 1990s, MFIs fulfilled a strong social purpose, because their operations were mainly funded by development partners for the alleviation of poverty. Since the early 2000s, they have shifted to commercial activities even though they still depend on foreign funds[61].In the early 2000s, the NBC established regulations for MFIs that encourage the development of microfinance[62]. Capital requirements and other prudential ratios for MFIs are generally lower than those that apply to banks[63], but they are subject to regular on-site and off-site monitoring to ensure that they remain sound.

Cambodia was the first country in the world to impose a remaining balance method for calculating interest expense on MFI loans[64]. MFIs now calculate interest expense by applying the interest rate to the remaining loan principal. Cambodians as well as the international community have welcomed this regulation.

The NBC classifies microfinance institutions into three categories according to their operations. Those whose activities are very small require no license or registration. Medium-sized MFIs must register with the NBC and submit reports to the NBC. Big operators must be licensed by the NBC and are subject to regulation similar to banks. To foster local funding of MFIs, in late 2007 the NBC authorized qualified licensed MFIs to take deposits[65]: they are known as Microfinance Deposit-taking Institutions (MDIs).

MFIs serve low-income earners, expanding their networks into remote areas where the population is poor. At the end of 2013, there were 2,176 MFIs, including branches and head offices of MFIs and MDIs, compared to 991 in 2006. At the same time, the number of people having access to the microfinance sector jumped from 3 per cent to 11 per cent of the total population and since 2012, some 5 to 6 per cent of the population have placed their savings in microfinance. The growing confidence in the sector together with expansion of networks and lower interest rates has helped to boost lending and deposits. The ratio of total loans and deposits to GDP has accelerated with year on year growth rates averaging 100 per cent per annum for deposits and 54 per cent per annum for lending between 2005 and 2013. It now stands at 9.73 per cent and 3.43 per cent, compared to only 1.2 per cent and 0.16 per cent, respectively in 2002. Moreover, some of the biggest MFIs/MDIs have developed lending products in the USD 10,000 - 50,000 range (World Bank, 2014), which can be used to finance micro and small investment projects.

[61] As of May 2014, 60% of funds are sourced from abroad. This figure was higher in the past. In 2010, it was two-thirds of total funding (Gardère, 2010, Khou, 2012). In just over ten years, 19 Cambodian microfinance institutions have been transformed from donor dependent into commercially viable institutions. (Cambodian Microfinance Association: http://cma-network.org/drupal/download/yellow_print/Microfinance%20in%20Cambodia.pdf)

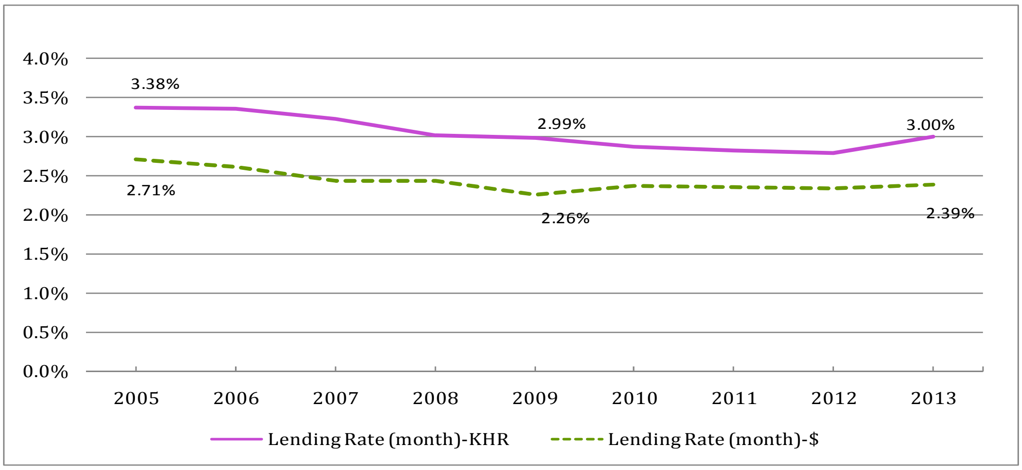
[62] *The Economist*, 2010

[63] For more detail, see annex.

[64] Order on the calculation of interest rates on microfinance loans, 2003.

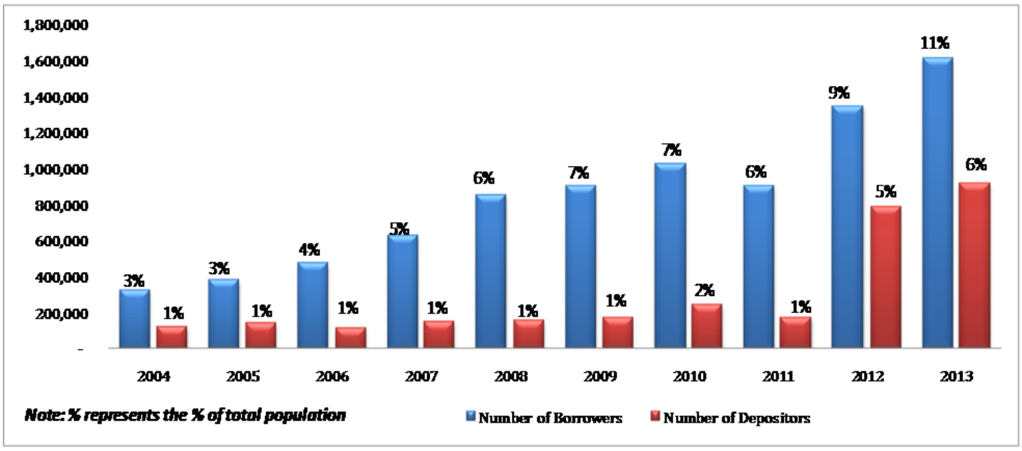
[65] Order on licensing of microfinance deposit taking institutions, 13 December 2007.

Figure 24. Monthly lending rate of MFIs in KHR and USD



Source: Banking Supervision Department, National Bank of Cambodia

Figure 25. Number of MFI borrowers and savers



Source: Banking Supervision Department, National Bank of Cambodia

Diversification of financial services: mobile banking service

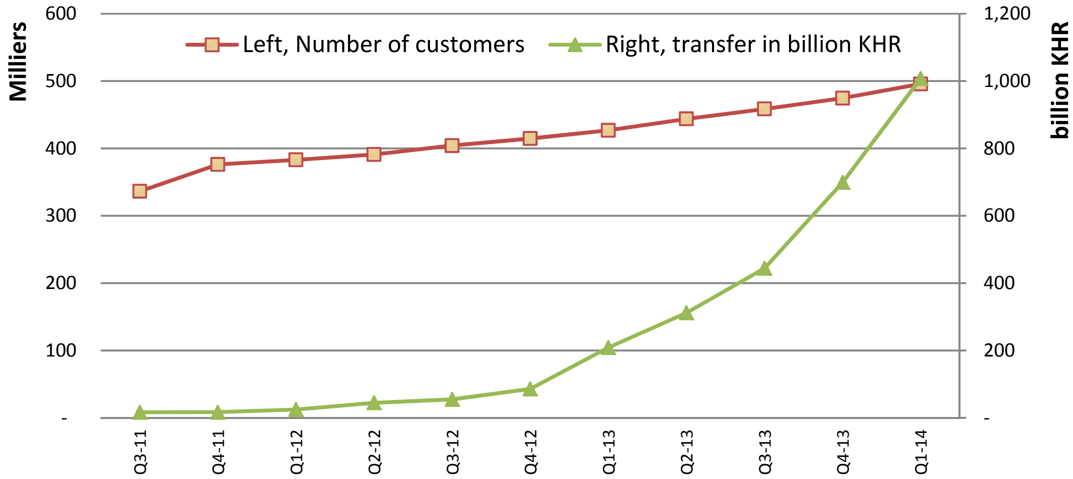
Growth, trade and the movement of workers between regions increase the demand for money transfer services. A survey conducted by Khou (2010) found that most transfers by households and businesses were handled money changers[66]. During the last 5 years, mobile banking services have also emerged[67]. One well-known provider, WING, entered the

[66] Money changers do not require any formalities, such as forms or ID cards, to effect the transaction and can provide a very fast service both for the sender and the receiver.

[67] In order to ensure the legality and the sustainability of this mobile payment system as well as protecting the customers using the services, the National Bank of Cambodia issued a regulation on third-party processors", which took effect from 25 August 2010. The regulation allows banks to outsource one or more parts of their payments services to one or more third-party processors, as may be agreed between the Bank and the third-party processor, and subject to prior approval from the National Bank of Cambodia, in conformity with Article 204 of the Act on Negotiable Instruments and Payment Transactions.

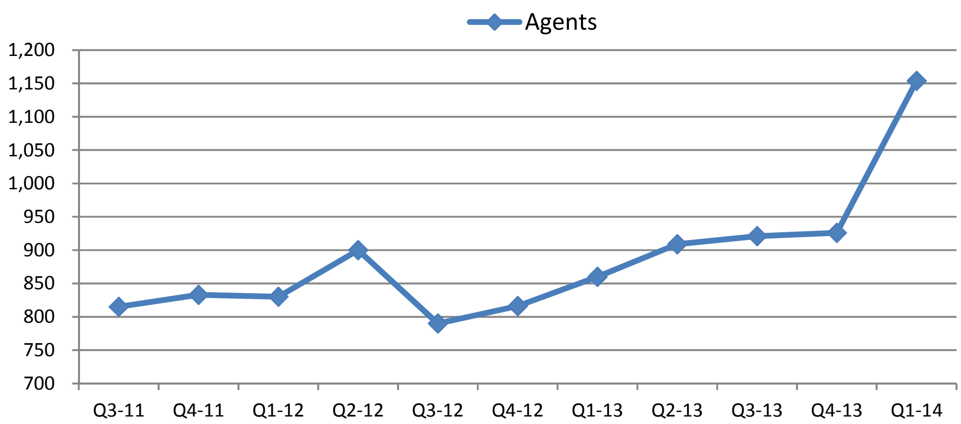
Cambodian market in 2009 to fill the gap between financial institutions and people who lack ready access to banks. WING provides customers not only with money transfer services but also deposit, withdrawal, bill payment, and phone top-up services. Today, there are about 1,154 WING agents countrywide, compared to 830 in 2012 (a 39 per cent increase). From late 2011 to early 2014, the number of customers also increased by 14 per cent, to reach 495,648 (3.4 per cent of the population). The total amount of mobile money transfers has now reached 1.7 per cent of GDP during the last two years.

Figure 26. WING's operations – number of customers and size of transactions



Source: Banking Supervision Department, National Bank of Cambodia

Figure 27. WING's operations – number of agents



Source: Banking Supervision Department, National Bank of Cambodia

Credit information sharing and payment system

Recognizing that informal activity accounts for much of the economy and that people who engage in these activities do not maintain audited financial records, in 2012 the NBC authorized the formation of the Cambodia Credit Bureau (CCB). The members of the CCB share accurate real time credit information, analysis and credit reports. Currently, 37 banks and 32 MFIs are members of the CCB. The information provided by the CCB reduces credit risk in lending and makes capital accessible to more businesses and households.

The NBC has also developed the payments and settlement system by organizing clearing houses in the capital and other regions to expedite the clearance of cheques. In late 2012, the NBC officially launched its National Clearing System, the centralized system in which all cheques are processed at the NBC's clearing house. The clearing house members have adopted the rules and procedures of the National Clearing System for settling their transactions. The new system processes transfers by cheque, and debit and credit transactions. In addition, the Shared Switch development project has been examining ways to facilitate cash withdrawals through interbank ATMs, internet banking, and mobile payments since 2013.

4. Challenges and future measures for the NBC to contribute to economic diversification and creation of productive employment

Because the explicit mandate of the NBC is to maintain price stability, the NBC's role can affect economic diversification and employment only indirectly. This section discusses the challenges facing the NBC in performing its roles and the measures it can take to promote diversification and employment.

4.1. Challenges

Although dollarization imposes constraints on its monetary policy, Cambodia will only de-dollarize in a gradual process. Dollarization exposes the banking system to liquidity risk, currency mismatches, exchange rate risks, and credit risks, especially when investors or depositors react quickly to political or economic shocks[68]. This exposure renders Cambodia's economy vulnerable to external shocks. In the event of a crisis, monetary policy would not be able to manage the crisis and restore the economy, because the NBC cannot act as lender of last resort.

Banks and MFIs in Cambodia are still mainly dependent on foreign funds, which would be exposed to risks of liquidity shortage and currency mismatch. According to the data on the microfinance sector obtained from the NBC's supervision department, as of December 2013, around 70% of their sources of funds are from abroad[69].

Most SMEs still lack access to finance[70] (IFC, 2010). Only 10% of enterprises have bank accounts, and only 20% can get bank loans[71]. Poor rural infrastructure constrains the expansion of banks and MFIs into rural areas that contain many SMEs. SMEs frequently lack the clear title to land that banks frequently require as collateral for their loans. Moreover, SMEs are hampered by their lack of information about financial services, and their lack of confidence in the banking system. High interest rates also restrain their demand for credit. All these obstacles could impede the Government's plans for promoting agriculture and the industrial sector.

The banking system has substantial excess reserves, representing an untapped capacity for expansion in 2012 and 2013, since only about half of these reserves are statutory reserves. Because excess reserves earn a negligible return compared to the interest rates they earn on loans, banks would benefit by expanding loans, especially to SMEs.

Interest rates at banks and MFIs are high compared to interest rates elsewhere in the region. In 2013, the annual interest rate at Cambodian banks was around 12 per cent, while it was only 5.5 to 7 per cent in Brunei Darussalam, Malaysia, the Philippines, Singapore and Thailand[72].

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[68] Cambodia's banking system has commonly faced liquidity shocks during General Election periods. In the last General Election in July 2013, about 8% of the deposits in the banking system were withdrawn. However, thanks to its resilience, the banking system remained stable and the deposits returned to the banks after a period of two or three months.
[69] This proportion has decreased compared to a few years ago when MFIs were not allowed to collect deposits. It was around 75 - 80% (Khou, 2012 and Gardère, 2010).
[70] For the 87% of surveyed enterprises with long-term funding, only 15% have bank loans, 64% of entrepreneurs use their own savings for long-term finance and 7% get financing from family and friends.
[71] World Bank (2011).
[72] World Bank data: http://data.worldbank.org.

The banking system is still young and provides mainly traditional financial products and services based on the current demand from the public. The total assets of the top eight commercial banks account for more than two thirds of total bank assets.

Cambodia's banking system is concentrated in a few places. Many banks are located in the capital city. In some provinces, there are only one or two banks present out of the 40 banks operating in Cambodia, due mainly to the low level of economic activity in those areas.

Box III

Constraints on economic diversification perceived by banks and MFIs

From a series of interviews with experts from the World Bank, ADB, IMF, the Supreme National Economic Council, the Cambodian Economic Association, banks, MFIs, trade unions, and relevant ministries, it emerged that:

To diversify the economy and to create more jobs, Cambodia requires a stable economy and a stable financial system. Although the banking system can promote development, it faces a number of constraints:

Sources of funds: because domestic saving in Cambodia is relatively low and some banks and MFIs depend heavily on foreign borrowing to fund their loans, the cost of credit is high in Cambodia. High interest rates add to the cost of doing business, making Cambodia's producers less competitive compared to their neighbours. High interest rates also discourage borrowing, especially by micro, small and medium-sized enterprises.

Lending constraints: many SMEs cannot meet banks' lending requirements. Banks and MFIs described a number of common constraints:

- Collateral: in Cambodia, lenders require hard land title as collateral for loans, even when applicants have financial reports. However, the majority of SMEs do not have such title, and people in rural areas have movable assets that are not accepted by banks and MFIs.

- Business registration: Most of Cambodia's SMEs are unregistered. Usually, banks and MFIs face difficulties in identifying these firms and take too much time to process their loan applications. SMEs often do not register to avoid complicated registration procedures, tax compliance, and fees during and after their establishment.

Financial reports: Almost all unregistered SMEs and some registered SMEs have no proper accounting records and financial reports. One of the three selected banks had rejected a large number of loan applications for lack of financial reports, because the bank could not assess applicants' capacity to pay their loans.

4.2. The way forward

According to Faisal Ahmed, IMF representative to Cambodia, the NBC's mission is clearly defined as price stability. Hence, it will not directly involve itself in economic diversification and job creation. State-owned banks provide the environment for investment: diversifying channels of investment is the best way to encourage economic diversification and create jobs.

The NBC can promote economic diversification and employment through its monetary policy and regulation and supervision of the banks to ensure macroeconomic and financial stability. It must also help to modernize the payments system and other financial infrastructure to promote fair competition among banks and foster more efficient financial intermediation.

Monetary policy

Cambodia's high degree of dollarization limits the effectiveness of the NBC’s monetary policy, as does the lack of an active money market. This could be overcome by shifting to a wider use of the riel in the banks and by introducing full auctions for its Negotiable Certificate of Deposits (NCDs) in the interbank and money market. This can complement other nascent financial market measures, including foreign exchange trading, in addition to its role as a lending facility.

Banking policy

To foster the development of the banking system, the NBC should create the financial framework to preserve the stability of the financial system[73]. It should also establish a crisis prevention, preparedness and management framework involving all the regulatory agencies: the Ministry of Economy and Finance, the National Bank of Cambodia and the Securities and Exchange Commission of Cambodia)[74].

In the future, Cambodia could adopt deposit insurance, which would reduce potential disturbances to the banking system by reassuring depositors that their deposits are not at risk. Deposit insurance could attract more depositors, and thus foster the expansion of banking services, especially in rural areas.

Banking regulations could encourage more protection and disclosure to bank customers. The NBC could encourage market transparency and disclosures, design and implement a programme to promote financial literacy among customers and the general public, and introduce and implement consumer protection guidelines based on experience and best practices, in line with pillar 3 of Basel II.

Modernizing the payments system

Because safe and efficient payments, clearance and settlement systems reduce the cost of doing business, the NBC should develop a real time gross settlement system to settle high-value transactions more quickly and economically. It should also adopt regulations that promote reliable mobile banking systems, which can serve micro entities and those who do not have access to banking services.

The NBC should: i) prepare regulations for electronic transfers and risk management, ii) provide standards for mobile phone messages, iii) monitor the performance of service providers, and iv) write regulations for electronic transactions, covering deposits, simple money transfers, and cross-border transactions. Eventually, the NBC should enhance the links between its payments system and those of its neighbours and with the rest of the world.

[73] The NBC established the Financial Stability Committee in 2011. Its roles are: i) to formulate and implement policies aiming at maintaining financial stability in order to support sustainable economic development; ii) to-introduce measures to support the NBC’s mission in managing liquidity and financial risks; iii) To monitor interactions among financial market participants, the objectives of monetary policies, and their impacts on banking system; iv) to analyse potential risks; and v) to analyse and monitor financial stability. The NBC also produces, for internal use only, the banking stability report, the Banking Stability Dash Board, on a quarterly basis.

[74] The Memorandum of Understanding (MOU) between the Ministry of Economy and Finance, the National Bank of Cambodia and the Securities Exchange Committee of Cambodia, was signed in July 2014. The MOU is an important step toward enhancing the crisis prevention, preparedness and management mechanism and framework, as it sets out the roles and responsibilities of the respective authorities in the normal times and times of crisis, and also enhances the collaboration and communication between the relevant technical staff.

Promoting financial access and inclusion

In line with the Financial Sector Development Strategy (FSDS) 2011-2020, the NBC should: i) bring unregistered or informal financial institutions into the formal system, ii) allow MFIs to offer additional services and products, iii) foster more economical information systems for MFIs, iv) provide MFIs with access to wholesale funds, and v) develop programmes or provide incentives that help the poor and people in hard-to-reach areas to access financial services. These might include fiscal and regulatory incentives, programmes to promote access to a range of financial services, such as micro leasing, microcredit, and micro savings, by the poorest segments of the population to enable them to improve their wellbeing.

Box IV

Perspectives from the interviewed banks and MFIs on the roles that the Government and NBC should perform to improve access to finance

Many banks and MFIs interviewed for this study responded that the NBC or Government as a whole should address:

- Land title: The majority of people in Cambodia do not have legal title to their land even though they have lived on the land for years. The Government's land title programme provided legal land title and social land concessions to Cambodian citizens in 2013. However, the programme only covered a small proportion of the country. The Government should help people to register their land with the local authorities, by simplifying the process and reducing the fee. Once people have hard land title, individuals and SMEs would find it much easier to obtain loans from banks and MFIs.

- Business registration: The Government should simplify the process for registering SMEs, reducing the time to issue a licence and the cost of obtaining it. Registered SMEs are subject to taxes as well as local authority charges, while unregistered SMEs avoid these costs.

- Financial reports: Private companies and SMEs should obtain audited financial reports. Even when businesses have financial statements, banks and MFIs report that some are not reliable.

5. Summary and conclusion

A review of the majority of studies finds that central banks in some advanced and emerging market economies promoted the development of their economies in various ways after World War II. In many cases, these central banks, as fiscal agents of their governments, provided credit subsidies, enforced capital controls, and applied asset-based reserve requirements in order to manage the allocation of credit. Often these policies resulted in excessive growth of money and credit, which produced high rates of inflation as well as inadequate allocation of resources. Consequently, they distorted credit markets, harmed the development of financial institutions, and hindered growth. Today, monetary policy fosters growth and employment by seeking low rates of inflation and by promoting stable financial institutions.

During the last two decades, Cambodia has witnessed high economic growth and stable macroeconomic conditions. However, the fundamentals of the economy are narrowly based and depend greatly on foreign demand, which makes it vulnerable to external shocks. Consequently, Cambodia needs to diversify its economy to achieve more stable growth to expand its capacity to employ people more productively. The Government has incorporated a plan to diversify the economy into its Rectangular Strategy as well as other sub-national and sectoral development programmes. However, major challenges remain.

As monetary authority and regulatory and supervisory authority of the banking system, the NBC has actively promoted economic growth and diversification, and employment creation. Moreover, the NBC’s missions and functions have become increasingly crucial, especially in the aftermath of the recent global financial crisis. To some extent, the NBC does not involve itself directly in increasing consumption, investment, government expenditure, and net exports, which are the driving factors of economic growth. Its primary mission is to conduct monetary and exchange rate policies to maintain price stability, thereby contributing to macroeconomic stability. The NBC also regulates both banks and other financial institutions and is custodian of the interbank payments system. Within its mandate, the NBC manages the foreign exchange rate and banks' reserve requirements to stabilize the foreign exchange value of the riel and the liquidity of banks. Cambodia's stable exchange rate has reduced its currency risk, which has fostered investment and has reduced domestic interest rates. It has also led to low and manageable inflation. This monetary policy supports macroeconomic stability in Cambodia which attracts a continuing inflow of foreign investment. The NBC also promotes and maintains financial system stability and development through promotion of financial inclusion, oversight of the payments system and regulation of the banking system. This has contributed to the efficient channelling of financial resources for capital accumulation in Cambodia over time.

However, Cambodia faces several hurdles in fostering economic diversification and employment in more productive jobs. The dollarized financial system in combination with the NBC's policy of managing the exchange rate, imposes strong constraints on the objectives of monetary policy, the financial system still relies on foreign funds, and many SMEs are not registered and do not have audited financial statements.

In view of these obstacles, the NBC can best support Cambodia's development by:

- Developing a programme for insuring deposits to further enhance confidence in the banking system.
- Fostering the continued development of the credit information sharing system, and introducing regulations that provide stronger protection for households and businesses.
- Developing a real-time gross settlements/delivery versus payment system, and promoting the creation of an electronic registry for all money market collateral.
- Further extending the payments system into rural areas to enable the banks and MFIs to offer deposits and credits more widely.

- Expanding the scope of the payments system to accommodate a broader range of transactions, including ATMs, e-banking, mobile banking, and commercial transactions.
- Developing a wholesale and formal foreign exchange market, with full auctions, to reduce the cost of relying on two currencies.
- Developing an open money and interbank market, with full auctions of NCDs, to increase the volume of safe collateral at market rates. Open markets and auctions will allow smaller banks and MFIs to provide their customers more financial services.
- Further promoting domestic savings through the introduction of financial literacy programme and providing more incentives to people to open an account, as well as simplifying the process.

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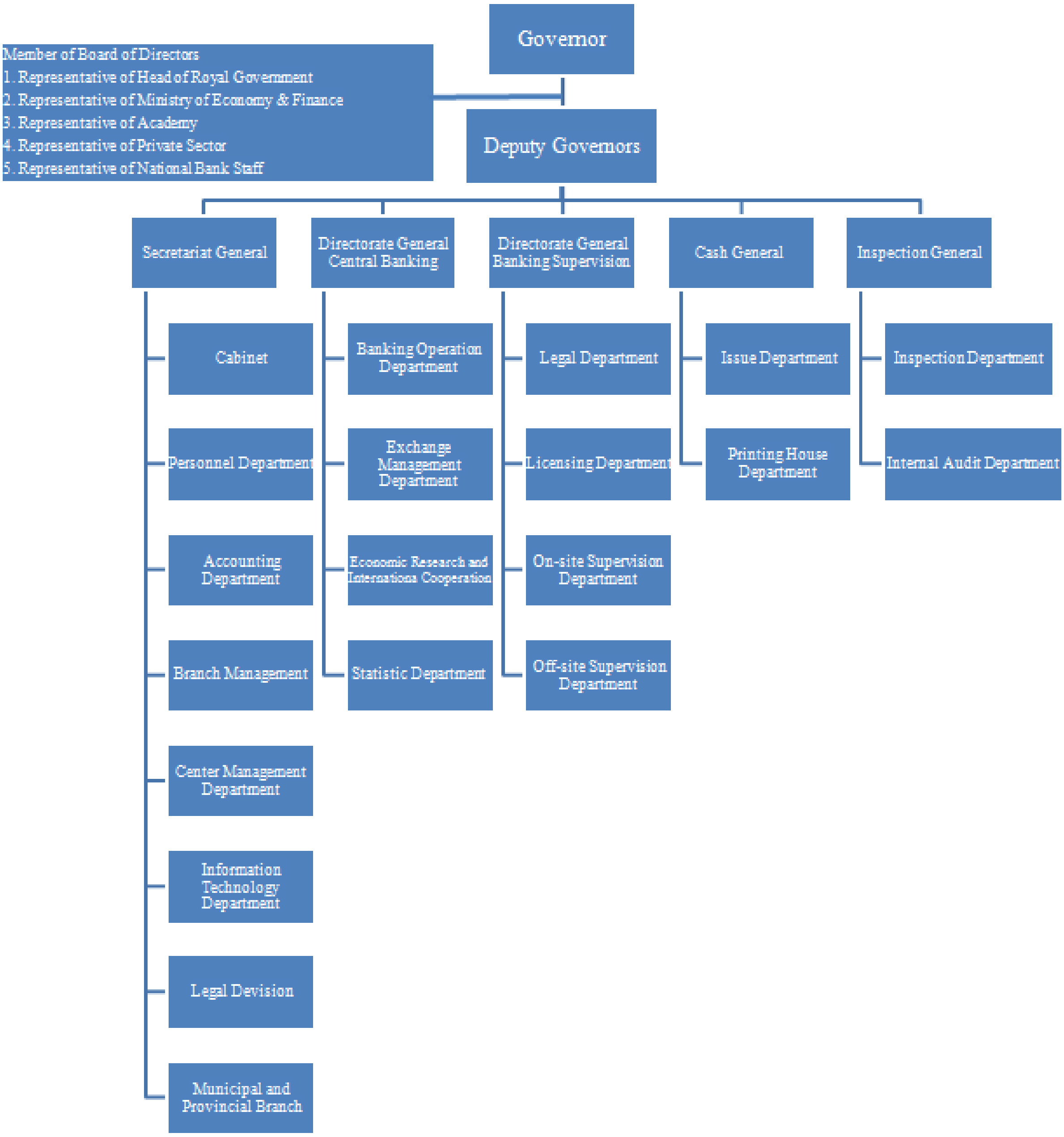
Annex 1. Key dates in Cambodian political and financial history

- November 9, 1953 — Independence from France.
- March 18, 1970 — Lon Nol coup d'état.
- April 17, 1975 — Khmer Rouges take Phnom Penh and empty the capital.
- January 7, 1979 — Vietnamese army enters Phnom Penh and establishes a new Government.
- 1980 — Reintroduction of the riel as domestic currency.
- October 23, 1991 — Paris Peace Agreements.
- May 1993 — National elections sponsored by the United Nations.
- June 1993 — Restoration of monarchy.
- July 1993 — Formation of a national Government.
- May 6, 1994 — IMF Enhanced Structural Adjustment Facility (ESAF I) programme.
- January 26, 1996 — Act on the Organization and Conduct of the National Bank of Cambodia.
- July 5-6, 1997 — Factional fighting in Phnom Penh.
- August 22, 1997 — Foreign Exchange Act.
- July 26, 1998 — National elections.
- November 23, 1999 — Banking and Financial Institutions Act.
- January 1, 1999 — Introduction of value-added tax.
- October 22, 1999 — IMF ESAF II/Poverty Reduction Growth Facility (PRGFO) programme.
- November 18, 1999 — Banking and Financial Institutions Act.
- May 31, 2000 — Deadline for submitting applications for a new licence for commercial banks.
- January 2, 2001 — Launch of a clearing house for dollar-denominated cheques.
- December 31, 2001 — Deadline for meeting the new capital requirement for commercial banks.
- January 1, 2002 — Acceptance of IMF Article VIII status.
- July 27, 2003 — National Election.
- June 26, 2008 — Circular on the real estate sector loan ceiling.
- July 27, 2008 — National Election
- January 26, 2009 — Withdrawal of the circular on the real estate sector loan ceiling
- July 28, 2013 — National Election.
- July 28, 2013 — National Election

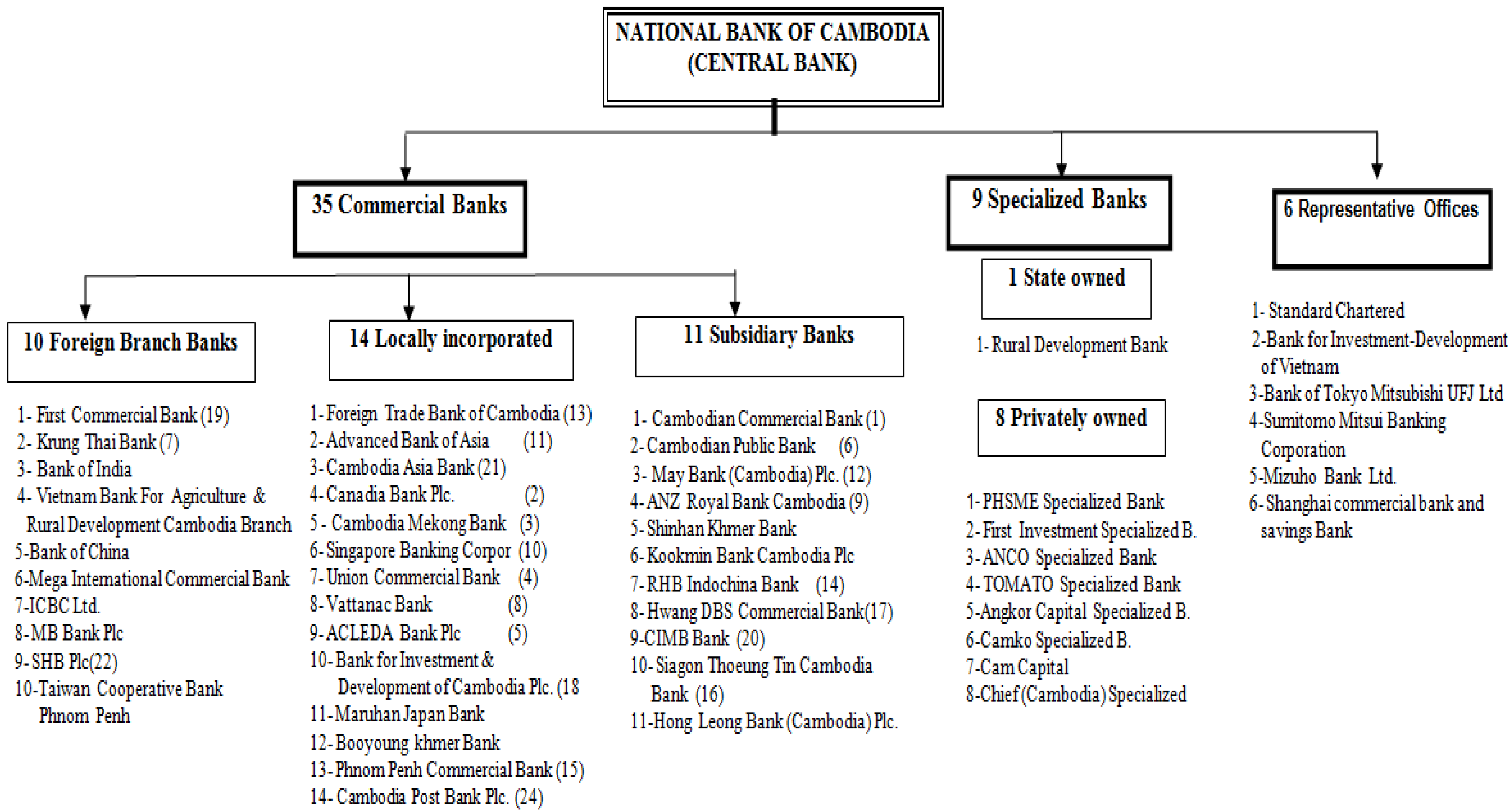
Annex 2. Key Indicators

Particulars	2005	2006	2007	2008	2009	2010	2011	2012	2013
REAL SECTOR									
GDP at current price (billion riel)	25,754.3	29,849.5	35,042.2	41,968.4	43,056.7	47,048.0	52,068.7	56,681.6	61,524.8
GDP at current price (million usd)	6,293.4	7,275.0	8,631.1	10,337.0	10,400.2	11,634.0	12,965.3	14,054.4	15,191.3
GDP Growth Rate (2000 constant price)	10.8%	10.2%	6.7%	0.1%	6.0%	7.1%	7.3%	7.6%	7.5%
GDP per capita (USD)	486.8	557.9	656.2	760.0	753.0	829.7	911.4	972.5	1051.2
Inflation Rate	6.1%	4.6%	6.5%	12.3%	3.1%	2.6%	3.4%	1.4%	0.8%
HUMAN DEVELOPMENT AND LABOR MARKET									
Poverty Rate			47.8	29.9	22.9	21.1	19.8	18.9	
Household consumption expenditure (per capita) in 000' riel	1632.4	1802.2	2,024.5	2,390.2	2,307.8	2,656.8	2,955.6	3,170.4	3,454.7
Life Expectancy at birth (total in years)	67.0	68.0	68.8	69.5	70.1	70.6	71.1	71.4	
school enrollment (preprimary % of gross)	11.3	12.1	13.0	13.6		12.7	12.7	14.9	
Health expenditure, public (% of total health expenditure)	22.1	17.6	23.7	18.6	19.4	22.5	22.6	24.7	
MONETARY SECTOR									
FCD/GDP	13.9%	17.4%	26.1%	22.1%	29.6%	33.7%	36.7%	41.9%	43.8%
FCD/Total Deposits	95.9%	97.3%	98.0%	97.0%	96.4%	96.8%	96.2%	95.7%	95.2%
Foreign Currency Deposit (mn riels)	3,589,417	5,195,972	9,137,650.1	9,274,491.0	12,749,337.4	15,847,606.3	19,127,102.1	23,766,366.1	26,944,950.9
Currency Outside Bank (mn riels)	1,282,144	1,599,550	1,989,737.0	2,294,774.6	3,001,601.7	3,098,628.5	3,771,652.2	3,755,612.7	4,453,792.1
Deposits in Riel (mn riels)	153353.6155	146739.3812	183,293.7	289,641.0	477,372.1	530,571.1	741,565.9	1,069,902.8	1,369,681.1
Exchange Rate									
Reserve Requirements									
Credit to private sector (mn riels)	2,393,650.9	3,627,724.1	6,384,773.3	9,893,493.0	10,513,684.6	12,975,108.0	17,021,262.1	21,792,905.7	27,608,794.7
Credit growth	31.8%	51.6%	76.0%	55.0%	6.3%	23.4%	31.2%	28.0%	26.7%
US dollar purchased	24.2	56.8	231.0	341.9	98.7	129.7	241.6	183.7	322.7
US dollar Sold	29.5	0.0	0.5	9.1	54.0	48.0	0.1	0.0	0.0
Net US dollar purchased	-5.3	56.8	230.5	332.8	44.7	81.7	241.4	183.7	322.7
EXTERNAL SECTOR									
Current Account Balance (excluding official transfers) in mn usd			-662.2	-1087.8	-675.4	-806.3	-881.9	-1366.0	-1899.1
Financial and Capital Account			497.2	798.1	421.1	436.7	522.8	1080.8	1655.6
Exports (mn usd)			3340.6	3505.3	3147.9	3938.5	5034.6	5632.8	6530.2
Tourist arrivals	1,305,328	1,700,041	2,015,128	2,125,465	2,161,577	2,508,289	2,881,862	3,584,307	4,210,165
Foreign Direct Investment (inflows)			754.5	750.4	511.1	735.2	795.5	1441.0	1345.0
BANKING SECTOR									
Total Assets	5,826.6	8,384.0	14,270.5	18,670.4	22,869.4	28,423.6	35,260.4	48,656.5	58,332.0
Banks	5,579.2	7,963.1	13,542.5	17,308.0	21,343.5	26,372.1	32,233.6	44,370.8	51,950.9
MFIs	247.4	420.9	728.0	1,362.4	1,525.8	2,051.5	3,026.8	44,370.8	51,950.9
Loans and Advances to Customers	2,407.0	3,944.9	6,950.8	10,867.0	11,704.6	14,873.2	20,451.2	4,285.7	6,381.1
Banks	2,201.9	3,584.8	6,327.2	9,910.9	10,467.1	13,146.2	17,842.0	26,371.7	31,599.0
MFIs	205.1	360.1	623.5	956.1	1,237.4	1,727.0	2,609.2	1,801.1	1,545.2
Deposits	3,745.3	5,335.9	9,329.3	9,433.8	12,996.7	16,064.4	19,442.3	2,826.6	5,291.9
Banks	3,736.6	5,325.4	9,307.8	9,406.9	12,956.8	15,898.6	18,976.6	42,079.3	54,339.2
MFIs	8.7	10.4	21.5	26.8	39.9	165.8	465.7	295.3	240.1
Number of borrowers	377,505.0	471,026.0	624,089.0	1,082,204.0	1,167,250.0	1,305,231.0	1,198,831.0	1,697,861.0	1,996,265.0
Banks				230,114.0	262,952.0	284,447.0	294,533.0	353,606.0	385,421.0
MFIs	377,505.0	471,026.0	624,089.0	852,090.0	904,298.0	1,020,784.0	904,298.0	1,344,255.0	1,610,844.0
Number of depositors	141,051.0	113,277.0	147,966.0	855,258.0	1,099,187.0	1,320,759.0	1,437,602.0	2,272,796.0	2,683,767.0
Banks				699,987.0	927,997.0	1,080,606.0	1,266,412.0	1,488,715.0	1,765,267.0
MFIs	141,051.0	113,277.0	147,966.0	155,271.0	171,190.0	240,153.0	171,190.0	784,081.0	918,500.0
Annual Lending Rates of MFIs									
Riel	40.6%	40.3%	38.8%	36.2%	35.9%	34.6%	34.2%	33.5%	36.1%
USD	32.5%	31.4%	29.2%	29.2%	27.1%	28.4%	29.0%	28.3%	28.7%

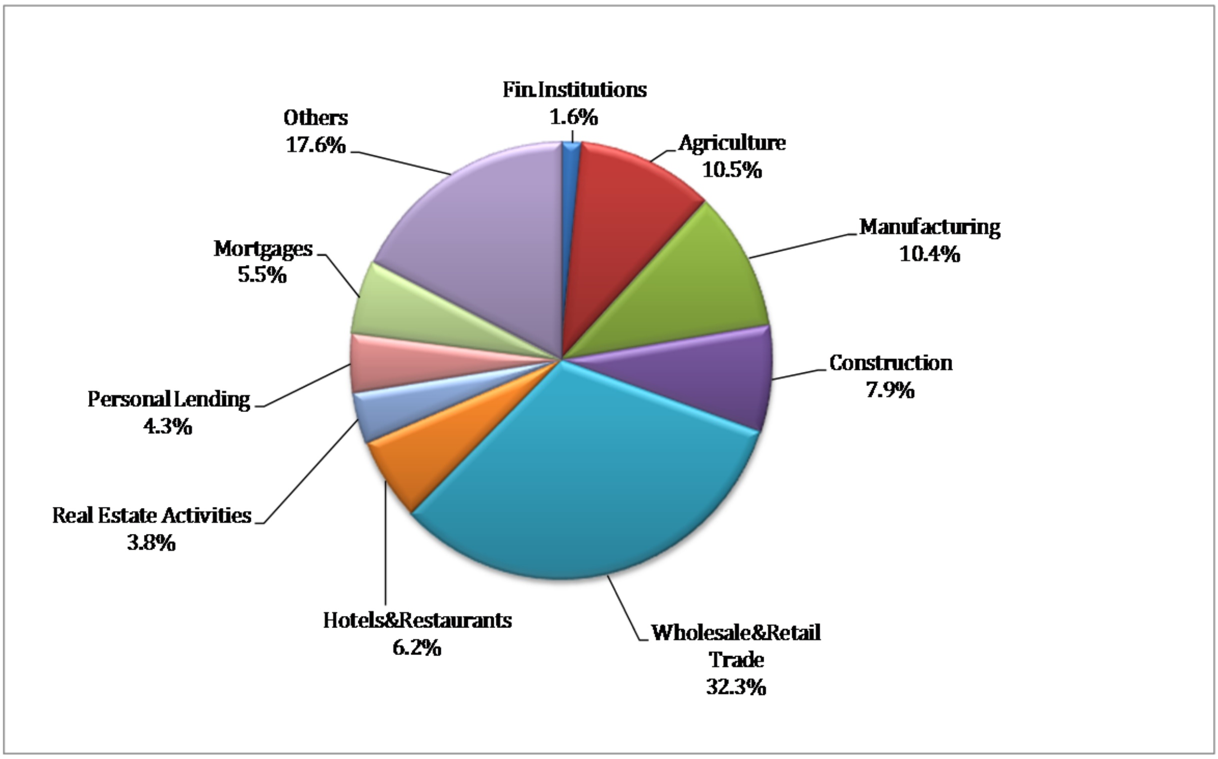
Annex 3: Structure of the National Bank of Cambodia



Annex 4. Banking System in Cambodia as of April, 2014



Annex 5. Shares of credit by industry -April 2014



Annex 6. Prudential Ratios

1. Reserve requirement:

- From 2000-2007
  - Bank : 8%(both KHR&USD)
  - Specialized Bank : 5% (both KHR&USD)
  - MFI : 5% of total deposit (no adjustment on this rate since then)
- In 2008 :
  - Bank : 8 % (KHR) 16%(USD)
  - Specialized Bank : 8 %(KHR) 5%(USD) (no adjustment on this rate since then)
  - MDI : 8% of total deposit (only effective from December 13, 2007 and no adjustment on this rate since then)
- In 2009
  - Bank : 8%(KHR); 12%(USD)
- From 2012-Present
  - Bank : 8%(KHR); 12.5%(USD)

2. Minimum Capital

- From 2000-2007
  - Bank : 50 Billion Riels
  - Specialized Bank : 10 Billion Riels
  - MFI : 250 million Riels
  - MDI : 10,000 million Riels
- In 2008- Present
  - Bank : 150 Billion Riels
  - Specialized Bank : 30 Billion Riels

Note: * Bank with shareholder rated investment grade : 50 Billion Riels
* Specialized Bank with shareholder rated investment grade : 10 Billion Riels

3. Capital Guarantee:

- From 2000-Present
  - Bank : 10% of minimum Capital
  - Specialized Bank : 5% of minimum Capital
  - MFI : 5% of minimum Capital
  - MDI : 10% (only effective from December 13,2007)

4. Solvency Ratio

- From 2000-Present
  - Bank : >15%
  - Specialized Bank : >15%
  - MFI : >15%
  - MDI : >15% (only effective from December 13,2007)

5. Liquidity Ratio

- From 2000-Present
  - Bank : >50%
  - Specialized Bank : >50%
  - MFI : >100%
  - MDI : >50% (only effective from December 13,2007)

6. Large exposure

- From 2000-Present
  - Bank : 10% of net worth
  - Specialized Bank : 10% of net worth
  - MFI : 10% of net worth
  - MDI : 2% to individual ; 3% to group (only effective from December 13, 2007)

7. Net open position

- From 2000-Present
  - Bank : <20%
  - Specialized Bank : <20%
  - MFI : <20%
  - MDI : <20% (only effective from December 13,2007)

Annex 7. List of interviewees

No.	Institution	Interviewees	Position
1	Ministry of Economy and Finance	Mr Ros Seileva	Secretary of State
2	Ministry of Labour	Mr Heng Sour	Director General
3	GMAC	Mr Kaing Monica	Deputy Secretary General
4	Cambodia Economic Association	Mr Heng Dyna	Chairman
5	SNEC	Mr Sovuthea	Section Chief
6	Norpun Research Institution	Mr Khin Pisey	Chairman
7	PRASAC Microfinance Institution	Mr Oum Sophan	CFO
8	Amret Microfinance Institution	Mr Chea Phalarin	CEO
9	Sathapana Limited	Dr Bun Mony	CEO
10	ACLEDA Bank	Dr In Channy	CEO
11	ANZ Royal Cambodia	Mr Stephen Higgins	CEO
12	Cambodian Public Bank	Mr Eric Tan Swe Huat	Deputy General Manager
13	IMF	Mr Faisal Ahmed	IMF Representative to Cambodia
14	World Bank	Mr Enrique Aldaz-Carroll	Senior Economist
15	World Bank	Mr Ly Sodeth	Senior Country Economist
16	ADB	Mr Doung Polling	Senior Economist
17	National Bank of Cambodia	Mr Chea Serey	Director General of Central Banking
18	National Bank of Cambodia	Mr Kim Vada	General Directorate of Bank Supervision

Annex 8. Questionnaires

Questionnaire for government ministries

1. What do you think what are the key employment and labour market challenges facing the national economy?
2. How does your Ministry contribute to job creation?
   a. Current policy in place
   b. Future policy designed
3. What are the main constraints on economic diversification?
4. As the Government is trying to diversify the economy, what new sectors should the Government should target?
5. How does your Ministry contribute to economic diversification?
6. What do you think about the prospect of the development of the four sectors (agriculture, garment, tourism and construction) in job creation in the future?
7. What do you think about the roles that National Bank of Cambodia should play in promoting economic diversification and employment creation?

Questionnaire for economic think tanks

1. What are the main constraints on economic diversification?
2. What sectors should be the next drivers of Cambodia's economy?
3. What are key employment and labour market challenges facing the national economy?
4. What roles of the NBC in accelerating economic diversification and employment creation? And what about roles of the Government in general?
5. How can the private sector play role in economic diversification and job creation?

Questionnaire for trade unions

1. What are the main constraints on economic diversification and job creation in Cambodia?
2. What are key employment and labour market challenges facing the national economy?
3. How does the trade unions contribute to job creation and economic diversification?
   a. Current action plan
   b. Future action plan
4. What should the Government do to promote economic diversification among the economic sectors, especially potential sectors, and create more job opportunities?

What roles do you think the National Bank of Cambodia could play in promoting economic diversification and employment creation?

Questionnaire for Banks and MFIs

1. What do you think about the roles that National Bank of Cambodia should play in promoting economic diversification and employment creation?
2. How does your organization contribute to economic diversification and job creation?
3. What the other potential sectors that your organization thinks that it will contribute to the economic growth and job creation in the future?
4. How your organization grants credit to those sectors in the former years, current year and in the future?
5. What are the challenges for your organization in expanding financial services to the poor and SMEs?
6. What is your perspective on how to improve financial access?
7. What are your perspectives on the development of the interest rates in Cambodia in the future?
   a. Cost of interest rate
   b. Interest rates on loans

8. What do you think about the effect of the current NBC regulations on your bank's performance?

Questionnaire for the NBC

1. In your own view, what are the key challenges in promoting economic diversification and job creation in Cambodia?
2. How has the NBC contributed to promoting economic diversification and job creation so far?
3. What are the constraints on the NBC in promoting economic diversification and job creation?
4. Could you share your strategies on promoting access to finance and financial inclusion?
5. Could you elaborate on the latest initiatives that the NBC has undertaken with respect to sector-specific credit allocation and lending to SMEs?
6. What is your view on the mandate of the NBC: price stability? Or financial stability?
7. What are future plans of the NBC for sustaining banking sector development and boosting economic growth?

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